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Research and Insights

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Outlook for equities: The macro-environment and the prospects for multi-year earnings growth

Faced with the headwinds of pronounced health and economic uncertainty, Ausbil's investment process successfully navigated the extreme contours of the 2020 pandemic, and the resurgent economy that followed the unprecedented flow of global stimulus. So what does 2021 and 2022 offer on the macro and equity outlook front? Ausbil's Paul Xiradis and Jim Chronis share their views on what lies ahead.

Paul Xiradis
Executive Chairman, Chief Investment Officer, Head of Equities

Jim Chronis
Chief Economist, Associate Director – Debt and Diversifieds

Q: What is your current top-down view?

A: The world is now in the process of controlling COVID-19 with a range of tested vaccines just over a year on from the original declaration by the World Health Organisation on 11 March 2020 that COVID-19 was officially designated a 'pandemic'. This is a remarkable achievement even though control of the virus remains a challenge.

We expect to see an acceleration in global growth to 6.6% in 2021 (Ausbil's outlook), with the US set to grow 7.0% in 2021. China was the first nation to emerge from lockdown in 2020. China is consolidating growth in the domestic economy and is expected to print an economic growth figure of 8.2% in 2021. Advanced economies are forecast to grow at multiples of their 10-year average, with Europe emerging from a double-dip recession caused from its second lockdown. Ausbil is expecting the Eurozone to grow by 4.7% in 2021.

Of all the pandemic stimulus packages, the US was far-and-away the largest, with the level of US fiscal support during the pandemic, so far, totalling US$5.2 trillion, 24.6% of nominal GDP, or three times the fiscal support given during the 2008 financial crisis. In addition, the Federal Reserve's open-ended QE program is providing monetary support to the tune of 11% of nominal GDP to date. Ausbil's current economic outlook is summarised in Table 1.

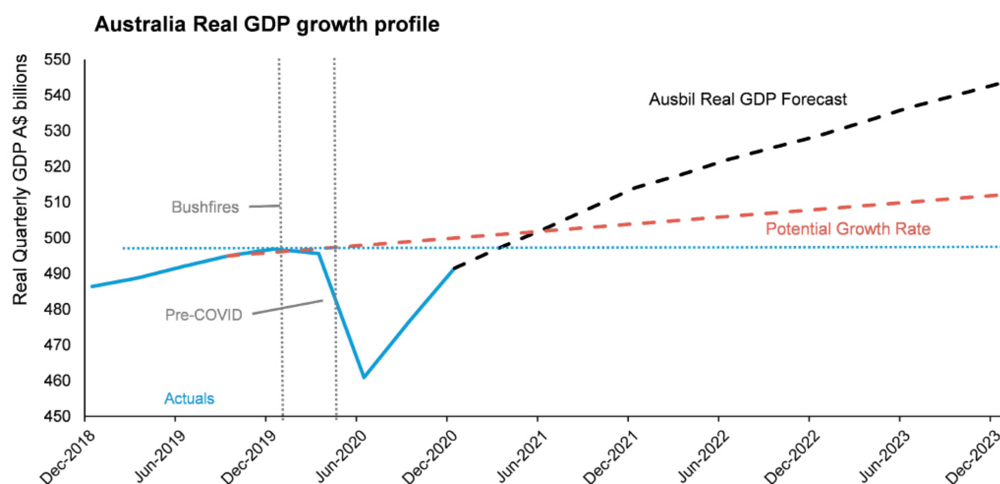
Table 1: The economy: Ausbil v consensus outlook

Real GDP % year average 27 April 2021	10 year average 2010 to 2019 %	Pandemic Actual 2020 %	Ausbil 2021 (f) %	Official Sector Concensus 2021 (f) %
United States	2.2	-3.5	7.0	6.6
Japan	1.1	-4.8	3.7	3.4
Eurozone	1.2	-6.6	4.7	4.2
China	7.7	+2.3	8.2	8.1
Australia	2.6	-2.4	4.9	4.5
Global GDP	**3.7**	**-3.3**	**6.6**	**6.1**

Source: FactSet, Ausbil, 2021

Massive stimulus and monetary support since the pandemic has also seen the Australian economy rebound from the two-quarter technical recession (with pandemic growth of -2.4% in 2020) towards a consensus growth outlook for 2021 of 4.5%, and an Ausbil forecast of 4.9%. Ausbil's forecast growth path for GDP, as illustrated in Chart 1, shows a pattern well above the potential growth rate over the coming years.

Chart 1: Australia's recover growth path



Source: FactSet, Ausbil, 2021

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Q. What are the risks to this macro outlook?

A: There are a number of risks to Ausbil's outlook. Recently, markets have been concerned about a permanent rise in inflation, what the recent rises in bond yields might mean for more persistent inflation, and the risk it poses to interest rate levels. These fears are also caught up with concerns around any earlier Fed response than expected, or any tapering of QE sooner than expected, that is, before the 2024 milestone, which has been set based on the emphatic and repeated comments by both the Fed and the RBA. These risks are associated with an economic rebound that is too successful, or successful too quickly.

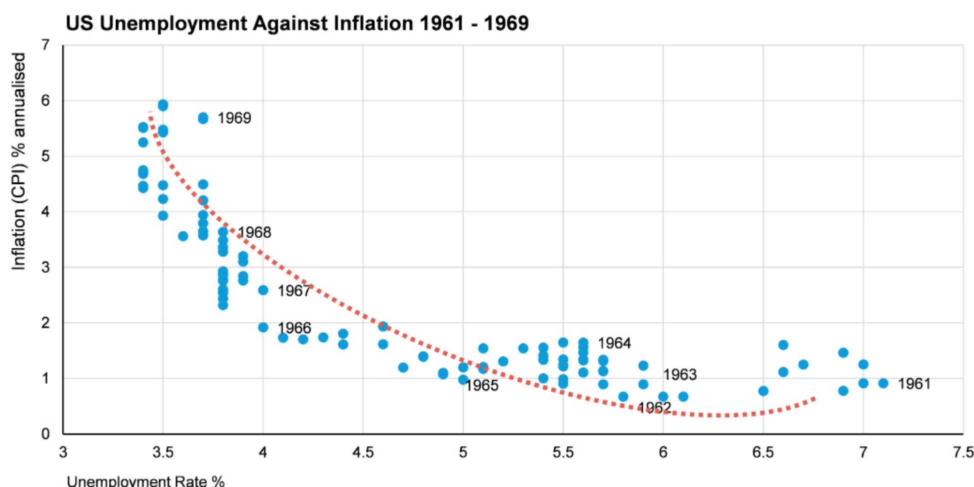
There are three conditions required before there is a lift-off in rates. Firstly, there needs to be a labour market that is at maximum employment. Secondly, inflation needs to have been at ~2% for at least a year. Finally, the level of inflation needs to be on track to exceed the 2% level "for some time," as noted by the Fed. These three conditions have never been simultaneously met in recent history.

Another risk is that growth actually underperforms, and the rebound is less than successful due to new COVID variants outpacing the efficacy of the current stable of vaccines. There also remains unquantifiable geopolitical and trade risks around the world, including the potential for regional conflicts in Iran/Israel, China/Taiwan, Russia/Ukraine, and now with actual conflict in the Middle East.

Q. Where can we look for guidance on how the economy is performing?

A: Will this ultra-accommodative policy experiment succeed or will overheating lead to a de-anchoring of inflationary expectations? We have a similar case study for a return to economic growth in the US economy of 1960-1969. The relationship between the unemployment rate (an inverse proxy for economic growth) and inflation during this period is plotted in Chart 2.

Chart 2: What can we learn from the 1960's?



Source: FactSet, Ausbil, 2021

The historical lesson from the 'hot' economy of the 1960s is analogous to our current situation, and shows that it took a number of years for inflation to become a material problem for the US economy in a multi-year growth pattern. Early in the 1960s, the unemployment rate starts high, and the inflation rate is low, as the economy is only just returning to growth. As the expansion gathers momentum, adding jobs and reducing the unemployment rate, the data shows a relatively static level of inflation for a number of years (between 1961 and 1965). After 1965, as unemployment is falling towards its full employment level, inflation becomes more sensitive such that by 1966/67, inflation has moved above 2%. In Ausbil's view, the US's current expansion is comparable to where it was in around 1963, representing the initial phases of what is expected to be a comparable multi-year growth cycle. A similar conclusion can be drawn presently for Australia.

Ausbil's view is that economies will run 'hot' for some time, with the support of policymakers, and are delivering the best growth figures since 1983, across a multi-year growth profile as illustrated in Chart 1. While inflation will remain an ongoing source of worry as the perennial flipside to growth, it is important to understand when inflation spikes are intermittent or if they are moves to a higher sustained level. It is our view, and indeed that of most global central banks, that inflation will not be a problem for some years as the world economy returns to health. We see inflation remaining within target ranges for some years, and cash rates on hold until 2024, with long bond yields to adjust over these years in an orderly fashion. Australia's economic growth, and the current resources boom, will underpin the Australian dollar, with Ausbil forecasting the AUD/USD in an up-trend: 75-80c for 2021, 80-85c in 2022, and 85-90c in 2023. This low-rate environment, and the multi-year economic growth outlook, is supportive of an underlying multi-year growth outlook for equities, especially in cyclical sectors, banks and in resources as world demand grows.

Q: Looking at equities now, what happened to earnings in the pandemic?

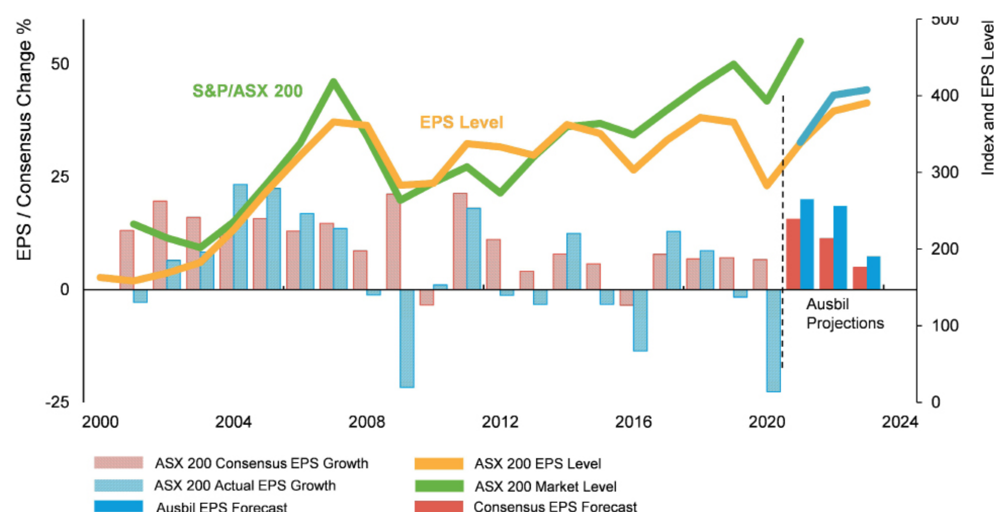
A: The announcement that COVID-19 was a 'pandemic' was made by the World Health Organisation on 11 March 2020, and heralded a period of stringent lockdowns and curfews that severely impacted the earnings of a range of industries, including: Retailing, Real Estate Investment Trusts, Health Care Equipment & Services, Infrastructure Trusts, Hotels Restaurants & Leisure and Transport (ex-Infrastructure Trusts).

On the flipside, a number of sectors were major beneficiaries of the lockdown 'stay-at-home' conditions brought about by the pandemic. Industries that saw earnings rerates included: Real Estate Investment Trusts leveraged to the warehousing and logistics of the booming e-commerce industry; Food & Drug Retailing, especially in staples; Automobile & Components, particularly in leisure craft and vehicles; Retailing to the stay-at-home online demand boom; Construction Materials, with travel and leisure spending re-diverted to renovation; and Software & Services, especially the online, cloud and buy-now-pay-later services that support the growth in e-commerce.

The other part of the market that boomed in 2020 and into 2021 was the resources market, Metals & Mining, with the ongoing fundamental demand for iron ore, strength in gold, and the rerating of metals needed for the renewable energy, battery storage and electric vehicle market.

Overall, the impact of COVID-19 on company earnings was worse than in the Global Financial Crisis (GFC), with earnings collapsing for the S&P/ASX 200 by -22.6% compared to the GFC earnings collapse of -21.7%. 2020's earnings collapse is well illustrated in Chart 3.

Chart 3: Earnings over time, EPS and market level for the S&P/ASX 200



Sources: Ausbil, FactSet, IBES, S&P, Refinitiv, Brennan Research, as at end February 2021.

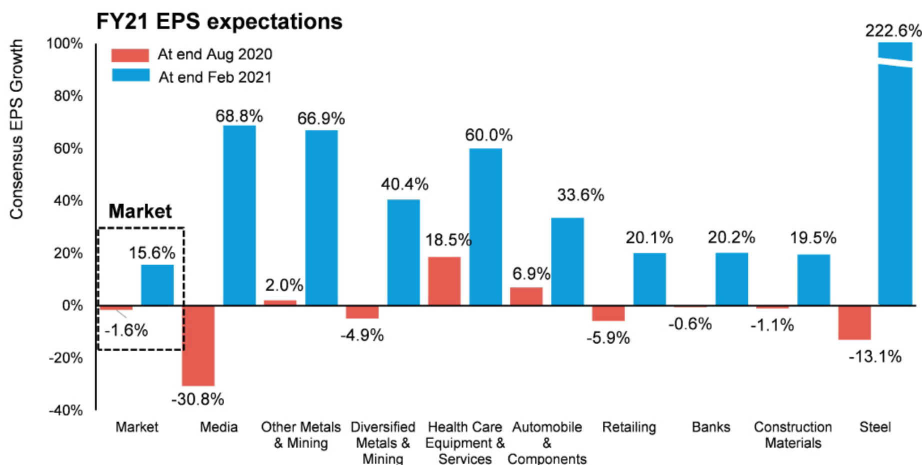
Q: You spoke a lot about quality balance sheets in 2020. Why is this important and how was it impacted by the pandemic?

A: In a crisis like the pandemic, perhaps one of the worst possible external demand shocks in memory, the shock to company earnings reverberated loudly. In some cases, a company lost practically all income. In this situation, to remain solvent, companies had to resort to balance sheet items like cash, debt and equity to offset the loss of revenue. Some companies have been prudent and successful in maintaining access to cash, debt and general liquidity. Others are highly leveraged and thin-margined such that a revenue shock like COVID rocks the very foundation of their business models. We found that well managed companies had a blend of undrawn credit lines and retained cash earnings and were able to reset their plans, furlough workers fairly and adjust their cost base to prepare for an eventual recovery. These quality companies, based on their track record, were also able to tap new capital from the market to help adjust for the new operating environment. We saw many new issues in 2020 such that capital raisings became a 'buyers' market'. In focusing on just the best-of-the-best, Ausbil was able to build and extend positions in quality companies at opportunistic prices, with these raisings setting up outperformance as earnings began to recover.

Q: With the economy returning to growth, how have earnings fared?

A: November 2020, when successful COVID-19 vaccine trials were announced, marked the point of inflection for when the possibility of returning to a relatively normal living and working environment became a reality. The record-breaking global fiscal and monetary stimulus packages were already turning economic indicators back towards the positive. The vaccines meant that governments and business could put a plan around a return towards normality. While earnings for the FY20 reporting season tanked by -22.6%, FY21 witnessed a dramatic turnaround in expectations from the prior reporting season, as illustrated in Chart 4.

Chart 4: The 2021 earnings outlook reversal



Sources: Ausbil, FactSet

From reporting season (end August 2020) to reporting season (end February 2021), consensus upgraded market earnings by an absolute +17.26%, from -1.65% to +15.61%. Underpinning this was major upgrades to sectors, including Steel, Media, Other Metals & Mining, Diversified Metals & Mining, Health Care Equipment & Services, Automobile & Components, Retailing, Banks and Construction Materials, as shown in Chart 4.

Ausbil's earnings outlook, set following the end of the February 2021 reporting season, has been well-ahead of consensus, with Ausbil's outlook for market earnings growth in FY21 at over 20+%, and over 18+% in FY22.

Q: How does Ausbil's outlook compare to consensus?

A: Results announcements in February 2021 confirmed the house view that earnings would rebound on the back of the extensive stimulus put in place in 2020. With the commencement of vaccines, and the easing of lockdowns in Australia across Christmas 2020, and into the New Year, the path for a return to more normalised earnings was apparent, though at that time Ausbil was well ahead of consensus on FY21 earnings growth by some 5+%, a significant amount. Consensus is now only starting to catch up with this view, though it is still lagging Ausbil by a significant percentage. What matters in the pursuit of outperformance is that Ausbil was able to set our portfolios with this earnings growth outlook in mind, and ahead of the ongoing market rerate, particularly in the sectors we like in this environment.

Q: Where do you see the earnings surprises coming from?

A: The two key sectors where we see further earnings surprise are the banks and resources sectors. Banks, which offer primary exposure to a recovering economy, entered the pandemic after heavy barrage from the Hayne Inquiry and having already been sold down. The pandemic saw them sold down further on fears that the recession and COVID job losses would impact their lending books. All the banks provisioned majorly for the potential for credit loss, and APRA further enforced capital retention through limiting the dividends they were allowed to pay. Looking at the banks in the 2021 New Year, it was evident that the bad and doubtful debt experience was nowhere near predictions, and that the banks had over-provisioned for losses. With APRA allowing a return to more commercial dividend levels, and the economy resurging from the 2020 lows, we could see banks were in a position to reduce these provisions and grow their books further in a renewing real estate market. The result is that over the next few years, the unwind of this over-provisioning will see a rerating of earnings, ahead of the consensus expectation at the time we began up-weighting into banks.

Metals and mining are in the midst of two fundamental themes in global resources investing. The first is the super-cycle demand for Australia's bulk commodities including iron ore, from China in terms of building and infrastructure demand, and as a function of the growth path of the world economy. This theme is expected to drive earnings in companies like BHP, Rio Tinto and Fortescue Metals. The second is the fundamental shift in the energy transition to renewable energy, and the rapid adoption of electric vehicles, which is sparking a secular demand for bulk, base and battery materials (copper, lithium, cobalt, zinc, manganese and rare earths) that is expected to last for decades, underwriting the fundamentals of a strong resources market. This long secular 'electrification' demand is forecast to drive earnings in companies like Galaxy, Orocobre and IGO (in lithium), OZ Minerals (in copper) and Lynas Rare Earths.

Ausbil has been overweight banks and resources (metals and mining) for some time. These overweights remain in place across our portfolios and have driven outperformance across our different strategies. Importantly, we are still in the early stages of the economic cycle, with a positive growth outlook for multiple years that is expected to drive performance in these mega-sectors.

The portfolio is also tilted towards rebound stocks in travel and recreation (such as Qantas and Webjet) whose earnings are returning following the implementation of global vaccinations, as well as high quality industrials and healthcare names (like Ramsay Health Care) which are primary beneficiaries of economic recovery.

Q: Equities: Where to from here?

A: Since the historic reversal in consensus across the February reporting season that saw the FY21 consensus earnings outlook for the broad market rebound from -1.6% to +15.6%, consensus earnings outlook for both indices has rerated to +19.08% (S&P/ASX 200) and +19.02% (S&P/ASX 300).

While these earnings figures are strong, Ausbil's house view is that consensus is still under-estimating the rebound in earnings that will occur in the prevailing economic conditions, with rates to remain low, and with the world economy providing a tailwind to Australia's current expansion.

In terms of the market itself, there are three important observations that can be made when looking at the earnings growth and levels illustrated in Chart 3. The first is that the consensus earnings outlook regularly misses the actual earnings by some margin, as illustrated by the blue and red bars in the chart. Moreover, in the expansion phase of 2004-2007, consensus significantly and consistently undershot actual EPS growth. What is interesting about this period is that it shows a multi-year expansion period of year-on-year positive EPS growth that could be similar to the period of earnings expansion we have just entered in 2021.

The second observation is that since the GFC, aggregate earnings have moved sideways, within a range. Market performance has been driven by significant P/E expansion in this time rather than earnings expansion. Ausbil's outlook is for the return of strong multi-year earnings over the next 2-3 years, and possibly beyond.

Finally, markets are volatile and can rise and fall on anticipated and unanticipated information. However, comparing the market and EPS levels in Chart 3 over time shows that markets tend to rise when earnings are in a rising pattern, or conversely, the market is unlikely to fall significantly when it is in an earnings upgrade cycle.

Ausbil's portfolios have been positioned for a clear path to recovery, but with some volatility and uncertainty along the way. We are expecting a multi-year earnings growth cycle, and we maintain the position that investors are compelled to participate. While we maintain a positive outlook on earnings, this is still a time to invest in only the best quality companies, which exhibit superior underlying earnings growth and strength, in order to achieve longer-term outperformance.

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