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Australia's resources tailwind and the outlook for equities

Research & Insights

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Ausbil's Paul Xiradis, Executive Chairman, Co-founder and Chief Investment Officer of Ausbil Investment Management, shares his thoughts on the outlook for Australia's economy, market and company earnings.

5-minute read

Key points

- Earnings growth will be hard to come by in FY24 because of the pressures of inflation, interest rate rises and a slowing economy.
- The market is still grappling with the impact of rising rates and inflation. Volatility reflects uncertainty about rates and growth.
- Inflation is likely to fall over time at a measured pace, towards central bank target levels.
- Ausbil expects low earnings growth in FY23 and FY24. Aggregate earnings camouflage both weak and strong sectors.
- Ausbil believes that Australia will outperform peers in the context of the overall slowing in world economic growth because of the global demand for natural resources, in which Australia is a global leader. Low unemployment, record levels of household savings, strong terms of trade, structural support for commodity prices, and net migration all support this view.

Q: What are the key drivers for earnings in the year ahead?

PX: The market is still grappling with the impact of rising rates and inflation. Globally, central banks are at the end of the tightening cycle, companies are in an adjustment phase to the new level of rates. The major gyrations in bond yields has generated significant confusion in markets as to the direction of inflation and interest rates in the near term. This volatility reflects uncertainty about rates and growth, and makes asset allocation more challenging. Adding to this uncertainty is the knock-on effect of the recent US regional bank failures, the demise of Credit Suisse and JP Morgan's emergency acquisition of First Republic Bank.

Our view is that inflation and interest rates are peaking. Inflation will continue to fall over time at a measured pace towards central bank target levels. The critical point is that the fade of inflation will happen over time, which supports our view that rates have peaked and will plateau. Any rate cuts, if they happen, are not likely to occur before late 2023 or early 2024 to ensure that the inflation genie is firmly back in its bottle.

Companies will adjust to more normal levels of interest rates, however, from an earnings perspective there will be significant pressures through this phase. Ausbil expects low earnings growth and wide dispersion, with aggregate earnings camouflaging weak and strong sectors.

The action of central banks across 2022 and 2023 to curb high inflation will see the consumer pulling back on spending, resulting in slowing growth.

Over the past year, the market has seen a vibrant discussion on whether the slowing economy will experience a hard or soft landing, and much of this depends on central banks avoiding policy mistakes in either direction. Ausbil's view is that, on the balance of probabilities, Australia will experience a 'controlled slowdown' (implying a soft landing) which affords the consumer and companies valuable time to adjust to the new cost of things. In summary, the path to

Paul Xiradis
Executive Chairman,
Chief Investment Officer
Head of Equities

Paul co-founded Ausbil in 1997 as an Australian equities house, building Ausbil into one of Australia's leading investment managers offering Australian and global equity funds.

Paul holds the position of Executive Chairman of Ausbil, Chief Investment Officer and Head of Equities. Paul has been instrumental in building Ausbil into a multi-billion dollar investment manager. Paul's role includes investment strategy, portfolio construction, Portfolio Management of Ausbil's flagship active large-cap Australia equities funds, and input into the investment management of Ausbil's funds. Paul is a member and Chairman of Ausbil's Portfolio Construction Committee.

He has been in investments since 1979, gaining experience with companies such as Westpac Banking Corporation's Investment Management Division, Mercantile & General and Legal & General Asset Management. Paul's career has included senior roles in management, investment and portfolio management in the funds management industry. Paul is an AAIBF Fellow, ASIA, FAICD, MNIA.

normalisation is more likely to be 'a journey rather than a destination'.

One of the key risks to Ausbil's outlook is the prospect of stagflation, which we would see if rate rises saw slowing demand, rising unemployment but stubbornly high inflation. This is not Ausbil's view but the risk is noted.

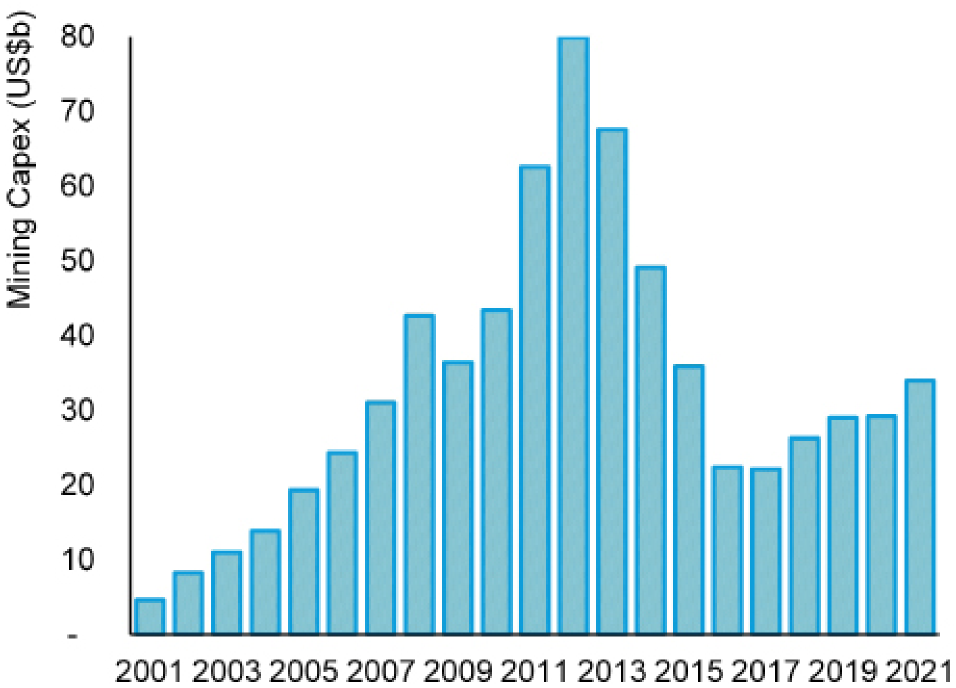
In this environment, Ausbil believes that Australia will outperform peers in the context of the overall slowing in world economic growth, though with a sub-trend level of growth currently estimated at around 1.7% for calendar 2023, with a slight pick-up into 2024.

Q: How will Australia fare with a slowing in global economic growth?

PX: Australia has a natural advantage in resources, doubly benefitted by fast-growing trading partners in the developing economies across Asia that encompass China and India. This is expected to benefit Australia and deliver growth in excess of our developed market peers in the coming year.

The economics for commodity prices are quite compelling. Firstly, there has been a chronic underinvestment in supply, as illustrated in Chart 1.

Chart 1: Underinvestment in resources supply



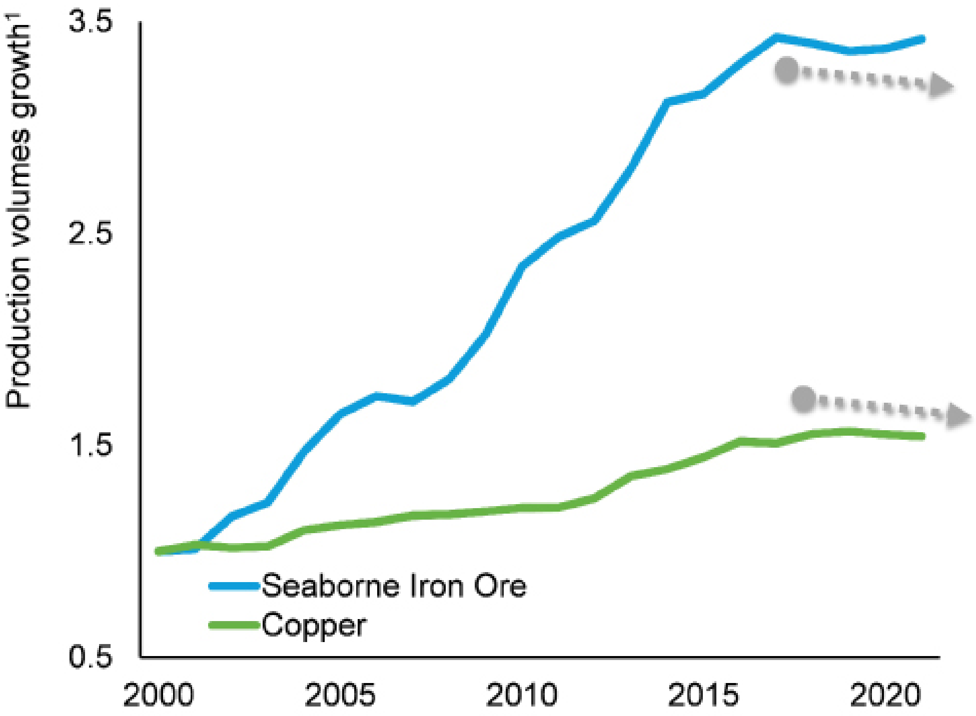
Source: Ausbil, Bloomberg (Top 10 global mining companies capital investment).

About Ausbil Investment Management

Ausbil is a leading Australian based investment manager. Established in April 1997, Ausbil's core business is the management of Australian and global equities for major superannuation funds, institutional investors, master trust and retail clients. Ausbil is owned by its employees and New York Life Investment Management a wholly- owned subsidiary of New York Life Insurance Company. As at 30 April 2023, Ausbil manage over $15.8 billion in funds under management.

As a result of the underinvestment in mining capex, supply growth has slowed materially, as shown in Chart 2.

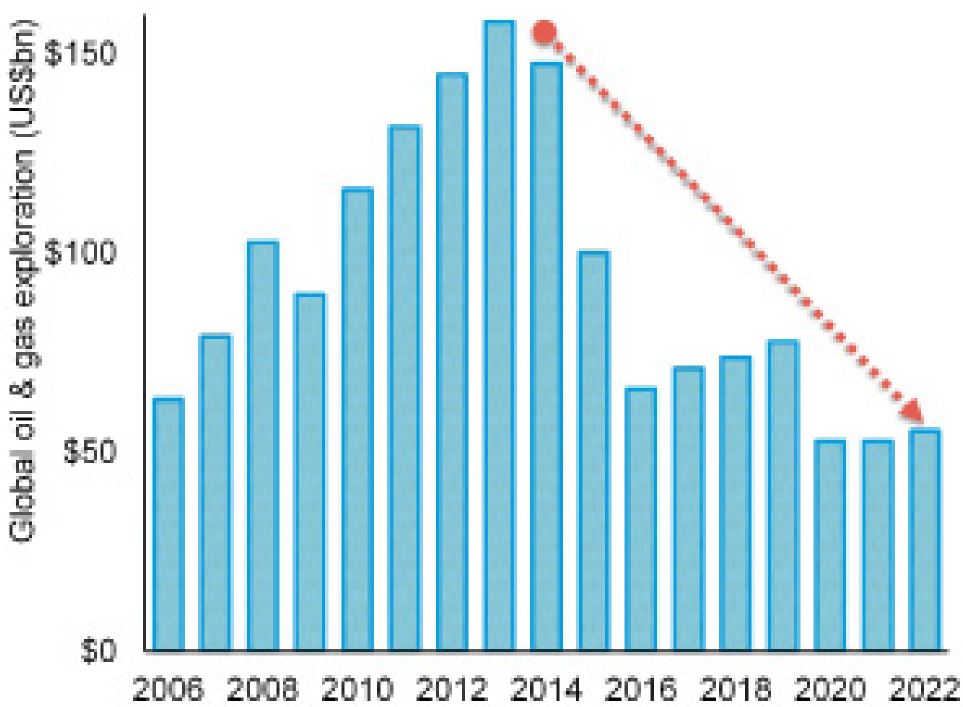
Chart 2: Production volume growth



Source: Ausbil, Bloomberg. Production Volumes growth relative to year 2000, indexed to 1.0.

We have seen similar disinvestment in oil and gas exploration over the last decade, as evidenced in Chart 3.

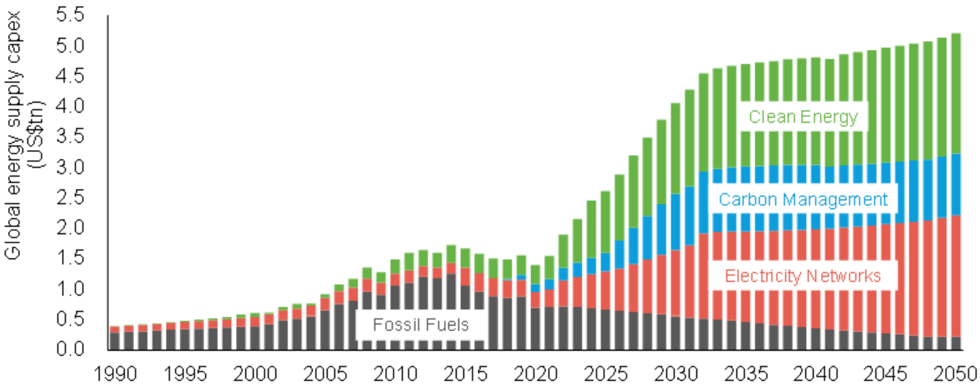
Chart 3: Oil and gas exploration has fallen



Source: Morgan Stanley.

This underinvestment in energy and mining capex coincides with a major upswing in renewable exploration spend which not only offsets the fall in fossil fuel exploration, but sees total energy capex increase by a multiple of some 2.5x of current levels out to 2050, as highlighted in Chart 4.

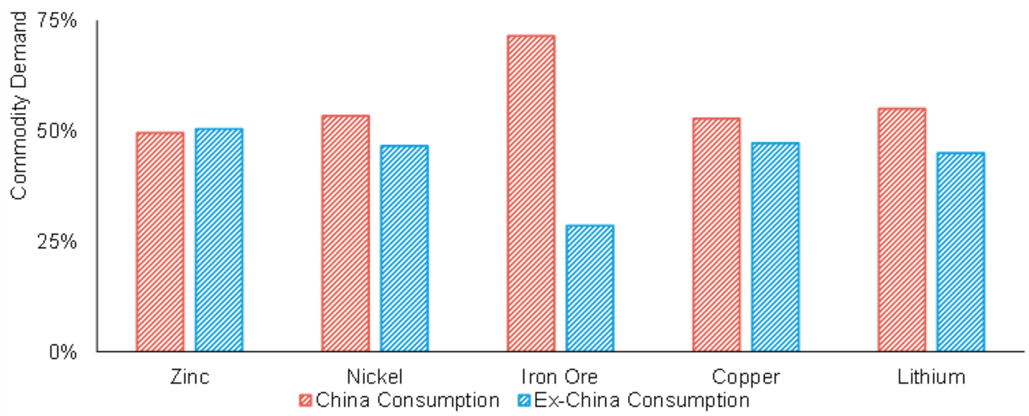
Chart 4: The boom in renewable energy capex



Source: Ausbil, UBS, IEA, IRENA.

The reopening in China is expected to see higher commodity demand in 2023 and 2024 than was experienced in 2022 with their rolling COVID-zero lockdowns. China accounts for a dominant share of commodity demand across the complex as illustrated in Chart 5.

Chart 5: China demand for commodities



Source: Credit Suisse, Bloomberg, 2021 base demand year.

Across the start of 2023, spot prices for key commodities remain ahead of consensus on the back of superior underlying demand and supply dynamics. These fundamentals are expected to further support commodity prices across calendar 2023 and into 2024, with an uplift impact on earnings in the resources sector.

Q: Where will earnings come from in FY24?

PX: Given the current environment we have described, Ausbil believes earnings will come from four key themes; peaking rates, and moderating inflation; earnings scarcity; companies that perform independently of GDP growth; and companies exposed to pockets of growth locally, and internationally.

Peaking rates – inflation moderating. As inflation is moderating, rates will peak and are expected to plateau, with some downward bias. In this environment, our view is that banks will feel some pressure through tighter NIMs (net interest margin), more competition for customers, tightening credit conditions and in BDDs which will normalise from recent lows.

However, on the upside, information technology, which had been significantly sold down across 2022 as a function of rising rates (given the inverse relationship between rates and growth companies), is expected to benefit as restrictive monetary policy plateaus and rates are held. We have seen this already in the rebound of information technology stocks globally in the first quarter of calendar 2023.

Earnings scarcity – quality leaders stand out. Ausbil's tilting towards certain quality leaders is further supported in an environment where growth is sub-trend, leading to a general scarcity of earnings in the market. Ausbil expects quality leaders in their sectors to excel on earnings growth (in some cases despite the drag on earnings for some of their peers), such as Goodman Group, Telstra, Macquarie Group and Treasury Wine Estates as key examples. In all these cases, the earnings outlook exceeds peers and system as these companies are in strong earnings growth phases because of the makeup and management of their businesses.

GDP agnostic – healthcare, staples and education. Slowing growth and earnings scarcity will see companies that are relatively 'GDP agnostic', meaning that they are capable of growing earnings across the economic cycle, such as companies like CSL and ResMed in health care, Woolworths in consumer staples, and Idp Education.

Pockets of growth – China reopens, decarbonisation continues. The critical thematic of China's demand for natural resources and demand from the world's push to decarbonisation continues to show pockets of growth even in a slowing global economy. Ausbil remains positive on the fundamental outlook in key metals and battery materials given low levels of inventory, support from ongoing economic growth in China, and from the long structural themes of decarbonisation, renewable energy, energy security, and technology-driven changes. Our view looking into FY24 is that this is supportive for earnings growth in commodities such as bulk resources in BHP and Rio Tinto, in energy such as Santos, and in energy capex in Worley, amongst other commodity exposures.

Q: We have been through quite volatile times in the last few years with COVID and then the energy shock? What are the key risks to equity markets?

PX: The last few years were unprecedented, but then we find ourselves saying that every five years now. We said it after the GFC, after the European sovereign debt crisis, and after Brexit. I guess what I am saying is that unprecedented risk is almost a 'new normal', and we need to invest accordingly. Fortunately, Ausbil's macro top-down approach helps identify, quantify and assess these risks in order to make more advantageous, and less risky allocations.

That said, there remains a number of key risks we are monitoring with respect to earnings growth. Stubborn inflation (input cost pressure, wages pressure) and rising interest rates (debt costs, slowing economic activity) are an ongoing risk we have to manage. Their impact in slowing economic growth to below trend, with heightened risk of recessionary conditions has made investing just a little more complicated in the current environment. Some pundits have even spoken of the risk of stagflation if the economy slows and unemployment rises without a fall in inflation, however Ausbil does not expect stagflation nor do we expect a recession given the relative strength in Australia's resources economy. Energy surety, short-term supply, and long-term independence is another economic pressure, but we also see this driving a faster push into renewables that again benefits Australia's resources economy. Consumer and business sentiment in a slowing economic environment and pressure on household balance sheets from the impact of higher rates, rents and costs of living is perhaps the most obvious risk, but again, there are equities options that can perform across the cycle when the consumer is weaker. Overall, in the challenges we also see opportunities.

Q: What is your outlook for equities?

PX: We believe inflation is in a peaking phase in response to the stringent central bank tightening program. The RBA paused in April but increased again in May, with a hawkish outlook and some risk that further small upward adjustments to interest rates could be needed, depending on the evolution of key data. Our view is that we are in the terminal stage of rate rises and we expect rates to plateau. The economy is slowing, and we see economic growth below trend in 2023 and into 2024. In this environment, we believe earnings growth will be harder to find. Compared to the stellar earnings growth of 22% in FY22 and 30% in FY21 in the pandemic rebound, we see positive but more muted growth for FY23. There is room for some upward surprise in certain sectors as Australia's economy remains relatively resilient and is operating near full employment.

We remain focused on the key thematics that are driving the long-term earnings growth, particularly where imbalances see demand exceeding supply on a fundamental basis for some time. We like critical metals and commodities for the long rotation from fossil fuels to renewables in the great decarbonisation, and the electrification-of-things, with the steady switch from combustion and fossil fuel power to renewable electricity generation. Service companies associated with the cap-ex investment needed for this energy transition are also attractive. With China re-emerging from its intense COVID issues, we see firmness in commodity prices as demand returns across calendar 2023.

The beneficiaries of elevated inflation are expected to perform in 2023, but the emphasis on those that perform well in a rising rate environment is starting to shift towards those that will benefit with stabilisation and peaking rates. Quality REITs, some quality leaders in technology, and some exposures in building products are helping to bridge the shift from the inflation beneficiaries that outperformed in 2022.

Q: What about Australia's future as an investment destination?

PX: Longer term, Australia is positioned as an economy to offer major investment and growth potential for listed companies Firstly, given the drive to net zero by 2050, the underlying push to decarbonise the world will require a lot of natural resources, particularly base metals, battery materials, bulk materials and energy. Australia is one of the best positioned economies globally to benefit from this fundamental change. Secondly, Australia's trade relationship with Asia, and China in particular, has greatly benefitted the country and will continue to drive demand for our exports in the coming decades. Thirdly, Australia is a young country that is set to grow steadily with migration and in size. There will be a compound growth benefit in how we develop our own export markets in knowledge, services, technology, commodities, agriculture, tourism and expertise, and how this manifests in investment back into local construction, real estate, infrastructure, services and consumer markets. These key themes, we believe, position Australia with significant advantage over our peers from an economic growth perspective. In our view, it makes a lot of sense to invest in Australia's future.

We believe Australia is similarly positioned for a long tailwind of economic growth, and while crises like the pandemic, wars and the recent energy crisis may hinder the economy in the short term, in the long run this tailwind of growth can drive compound returns for patient investors. A critical aspect to this tailwind of growth will be Australia's position as a key natural resources economy, though it will also manifest in Australia's education and health care exports, and in the internal growth of our economy. Australian large-cap stocks offer an ideal vehicle in which to invest in the compounding benefits generated by key thematics, and by the ongoing compounding growth in Australia's population and economy. An active approach with a track record of long-term outperformance can only accelerate the benefits of such an approach.

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