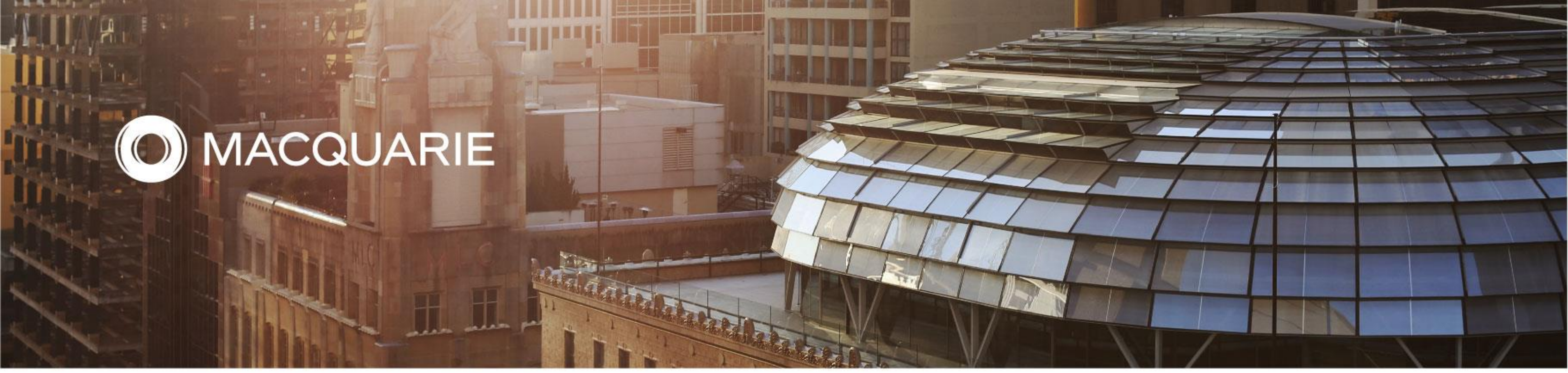


Investment Strategy Update #139

Cautious and Defensive – Takeaways from Macquarie's 2023 Australian Conference

- 108 companies presented at the Macquarie Australia Conference over May 2-4, 2023. The conference was held in person with a strong recovery in offshore attendees following the return of post-Covid travel, signalling a desire to interact and hear from corporates as the domestic market heads toward economic slowdown.

- The tone of the conference was consistent with a high level of cautiousness shown by households, business and government over the past 6-12 months as they navigate rising borrowing rates, tighter liquidity, a rolling slowdown across consumer exposed sectors and a more uncertain economic outlook.

- While there remain areas of concern (such as overleveraged consumers), there were also a number of bright spots (bottoming in housing, falling input costs) alongside the assumption that Australia will weather the impacts from policy tightening better than most of its developed market peers. Historically the conference has been seen as the start of the confession season in the lead up to full year earnings results, and while the tone was somewhat defensive, downgrades were not widespread.

- We highlight four key takeaways from the conference:

    - **Consumer facing areas continue to slow** (but not collapse) as the effects of rising rates penetrate household balance sheets, from the depletion of household savings buffers to rising mortgage repayment costs as fixed-rate mortgages roll off.

    - **Inflation pressures faced by corporates are moderating**. Labour cost pressures are showing some signs of easing as labour availability improves off the back of the post-Covid reopening and the return of immigration, alleviating some of the input cost pressures that have been weighing on businesses.

    - **Cautious optimism towards housing following a bottoming in home prices**, with operating trends across residential REITs improving following the RBA's pause in April. However, the recovery path is still nascent and it remains to be seen the extent to which May's surprise move will impact in the short term.

    - **Environmental, social and governance issues remain front of mind**, with a notable uplift in discussions on social and governance issues around cyber security, labour supply, community relationships and social licence to operate. This was a shift from recent years where more focus was directed toward environmental issues as well as social factors such as working from home.

- We believe insights from the 2023 Australian Conference are broadly consistent with our view that the Australia economy is slowing down but in a controlled manner. There are pockets of stress, but corporates appear well positioned to navigate through. We have maintained a defensive stance on Australian equities as tailwinds that had driven outperformance last year, versus global developed peers, unwind. Looking ahead, we see the domestic equity market facing several headwinds which make its risk-reward profile poor versus global equity peers and bonds (see this month's *Investment Matters – Volatility to persist*).

See "*Australian Equity Strategy – Australia 2023 Conference Wrap", 5 May 2023*, and "*Australia ESG Equity Strategy – Macquarie Australia Conference 2023: Key ESG Takeaways", 5 May 2023* for more detail.

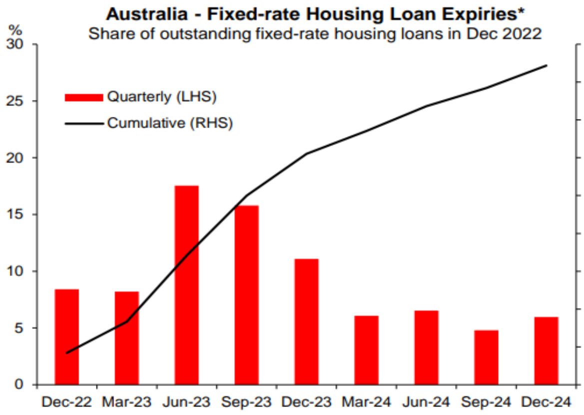
Key takeaways from the 2023 Conference

We highlight four key takeaways from the 2023 Conference:

1. The Australian consumer is slowing:

Multiple companies emphasised ongoing signs of consumer demand slowing. Despite the lowest unemployment rate in decades and the return of immigration also providing a boost to domestic activity and demand, companies are expecting consumers to trade down as household budgets come under increasing pressure from the RBA's tightening cycle, as more fixed-rate mortgages roll-off and as household savings buffers deplete, all of which will place downward pressures on consumer spending. In particular, Macquarie expects areas that benefited from Covid-driven demand which are now being impacted by rising interest rates to be most affected:

Half of fixed-rate loans to roll off by 3Q23



Source: ABS, RBA, Macquarie Macro Strategy, May 2023

- Within Consumer sectors, Macquarie remains cautious on Discretionary given pressures on household balance sheets and the expectation of higher unemployment, with discretionary demand already slowing before unemployment has started to rise. Travel remains a bright spot, with several companies providing upgrades to guidance as pent-up demand supports sales.

- Within Staples, the theme of consumers trading down was also evident, with supermarkets noting that consumers were switching from red to white meat, from fresh to frozen vegetables, while also buying in batches, as well shifting to generic brands.

- Macquarie also sees a rotation out of the yield beneficiaries that have performed well since the start of the rate hike cycle as the RBA heads closer to the end of its tightening cycle (Macquarie expects one more rate hike this year, to take the cash rate to 4.10% by August).

2. Inflation is easing:

While the spotlight from last year's Conference was on rising input cost pressures everywhere, including labour, supplies and costs of debt, this year companies have flagged a normalisation in input costs, in particular as labour availability improves off the back of borders reopening and immigration returning.

- Industrial and Mining companies both called out easing labour cost pressures and improving labour availability, after feeling the impact last year of major skill and supply shortages.

- The Health Services sector appeared to be one area where labour cost pressures are still more acute, however Macquarie sees an earnings recovery as volumes improve, and industry fundamentals remain robust (ageing population, increased government funding).

Availability of labour improving through 1Q23

Source: ABS, Macrobond, NAB, Macquarie Macro Strategy

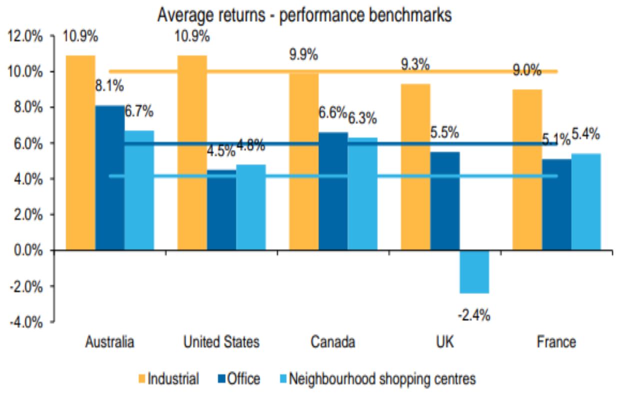
3. Cautious on short-term recovery but long-term tailwinds remain for Australian housing:

Housing recovery was a key theme, with residential REITs calling out an improvement in operating trends following the RBA's decision to pause in April. However, the housing recovery is nascent and it remains to be seen how much May's surprise move will impact in the short term, with domestic REITs underperforming following RBA's hike announcement. Nevertheless, there was optimism for the sector longer-term, with companies highlighting several structural tailwinds and opportunities:

- Companies saw compelling tailwinds for the sector from Australia's strong migration and economic growth outlook (forecast population growth of 1.5% p.a. and forecast GDP growth of almost 3.0% p.a. between 2020-2032), which compares favourably to other developed nations, as well as a structural housing shortage, with 'build to rent' flagged as an attractive investment opportunity.

- In terms of sector weakness, REITs acknowledged risk to Office values, although they also indicated less risk for the higher quality assets that are typically owned by listed REITs. On capital allocation, REITs are shifting to Industrial and Residential, and away from Office.

Australia's average returns across property favourable versus global peers



Source: MSCI All Property Index, CHC, Macquarie Research, May 2023

4. Environmental, Social and Governance issues:

While environmental issues remained prominent, there was a notable uplift in discussions on social and governance issues such as cyber security, labour supply, community relationships and social licence to operate. In particular, cyber security was in the spotlight, with recent cyber-attacks having highlighted the importance of a robust and well tested cyber response plan.

Within decarbonisation, discussions have shifted from target setting to decarbonisation implementation, with ~80% of mining companies now having a net zero target in place. Opportunities highlighted included providing technological solutions to the resources sector in the transition to renewable energy. Discussions around the role of gas as a transition fuel was also prominent, with recent geopolitical events having emphasised the importance of energy security, reliable supply and affordability.

What does this mean for investors?

We believe the insights from the Conference are consistent with our cautious view on Australian equities. We have maintained a defensive stance on Australian equities as tailwinds that had driven its outperformance versus its global developed peers last year unwind. Looking ahead, we see the domestic equity market to face several headwinds including: 1) earnings weakness in cyclical sectors such as resources (of which we have a structural overweight) as global economic growth slows significantly, 2) a slowdown in consumer demand, as the impact from rising rates penetrate household balance sheets, depleting savings buffers and increasing household debt burdens, and 3) a weakening financial sector as net interest margins come under pressure and ongoing mortgage competition weighs on profits and impacts overall market performance. Ultimately, we think the near-term risk-reward for domestic equities looks poor versus global equity peers and bonds, which are more attractive on a risk-adjusted basis given the return in yields.

Macquarie WM Investment Strategy Team

The report was finalised on 8 May 2023.

Recommendation definitions (Macquarie Australia/New Zealand)
Outperform – return >3% in excess of benchmark return
Neutral – return within 3% of benchmark return
Underperform – return >3% below benchmark return

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