Research
Macquarie Wealth Management

Investment Strategy Update

Why we are less worried about valuations

1

The Australian market P/E has rebounded to ~18x, close to the all-time high of 19x. P/E expansion is normal coming out of an economic downturn as equities pre-empt a recovery, but low interest rates and extreme levels of liquidity are boosting valuations even further than normal.

2

The market is expensive on short term valuation metrics and this makes the near-term risk-reward unappealing. However, based on longer-term (more normalized) earnings expectations, valuations have corrected significantly, and equities are more reasonably priced.

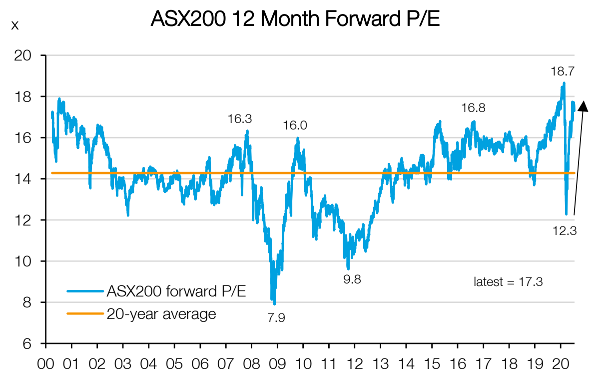
3

A high P/E is a better signal for long term rather than short term performance. Hence, a high P/E does not signal a correction is imminent for Australian equities. But it does mean there is little cushion for disappointment on the expected recovery.

How expensive is the Australian Equity market?

The Australian equity market's (12-month forward) P/E multiple has surged during the recent market rally to almost 18x (from its 23rd March low of 12.3x) and is closing in on its recent market peak P/E of 18.7x.

The 12-Month Forward P/E Has Re-Rated To ~18x



Source: Factset, MWM Research, May 2020

This has led to calls that the market is overvalued and that the "disconnect" with economic and earnings fundamentals will need to be corrected by a market decline. We don't agree with this simple assessment.

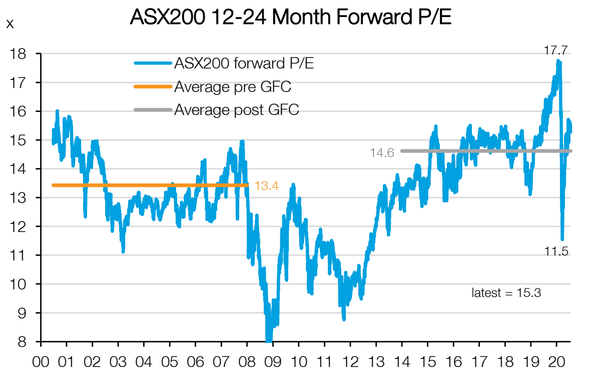
The rally from March 23 has pushed valuation metrics to levels which are concerning – we do not dispute this.

Because a lot of "hope" is now in the price of risk assets, this makes the near-term risk-reward outlook poor. But this does not necessarily mean equities are on the cusp of a correction. Rather it means that the cushion for disappointment is low. We don't see anything out of the ordinary with the rebound in the market and/or the resulting sharp increase in valuations. We think there are several factors that investors must keep in mind when assessing the valuation outlook for the equity market.

1. Equity market prices are a forward-looking indicator. Earnings lag the turning point in the market and hence **during economic downturns, it is normal to see a sharp rise in the P/E multiple.**

2. The recent surge in the P/E reflects the market's belief that the collapse in earnings is only temporary. **Using longer term earnings expectations (12-24 months) the P/E multiple is meaningfully lower** and much closer to levels seen between 2014-2018.

P/E less elevated when based on EPS 'further out'



Source: Factset, MWM Research, May 2020

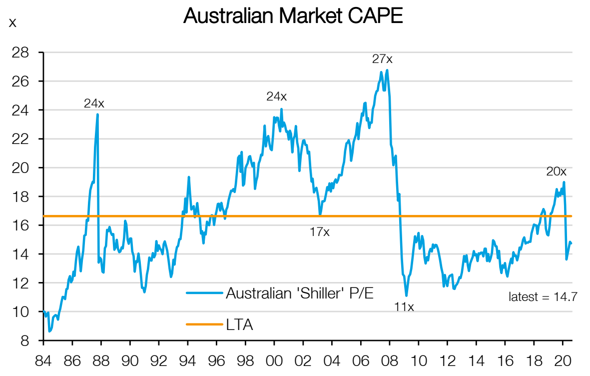
3. **Valuations are not a good predictor of short-term returns, but they are a much better predictor of long-term returns** (i.e., 10 years). Buying equities on an elevated P/E says more about the return an investor is likely to get out through 2030 than out through year end 2021.

4. Equities have traded expensively since 2014 (when they normalized post the European debt crisis) but **relative to other assets (bonds in particular) they do not look excessive** particularly given the latest rally in bonds which has pushed yields below 1%.

5. On a cyclically adjusted PE multiple (using earnings over a 10-year period) which adjusts for short term fluctuations, **the Australian market is trading well below the long-term average**. In other words, while the PE looks expensive on near term earnings, the valuation has corrected substantially on a through the cycle measure.

6. **The market PE ratio hides a widening valuation dispersion within the market.** As the market has rebounded, the premium paid for "growth" stocks has continued to widen versus "value" stocks. Thus, there are large parts of the Australian market that are looking relatively cheap despite the rally.

The Cyclically-Adjusted P/E Is Not Particularly High

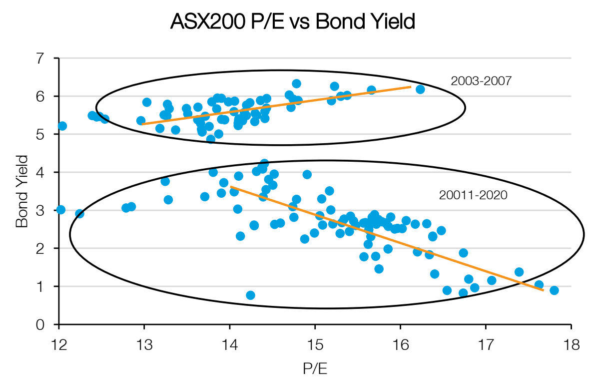


Source: Factset, IRESS, MWM Research, May 2020

Do lower rates post COVID-19 justify a higher P/E?

Post the GFC, valuations for risk assets have been higher than the pre GFC long term average. In part, this reflects the decline in bond yields and their impact on the cost of capital. With interest rates likely to be even lower in a post COVID-19 world, does this justify an even higher valuation multiple for equities? All things equal it should, but it might take time for risk premiums to fall and/or earnings growth rates to normalize. We think it is more likely that companies which benefit from COVID-19 disruptions will trade on higher multiples and that this will result in greater valuation dispersion within the index rather than a higher aggregate index multiples, for the near term.

Bond yields & PE correlation has changed through time



Source: Factset, MWM Research, May 2020

Which stocks are screening "cheaply" on a 'cyclically-adjusted' basis?

Just as the market's P/E looks high using near-term earnings but looks more benign using 'medium term' earnings, so the same analysis can be applied at a stock level. We run the following stock screen:

- ASX200 stocks rated Outperform within the Macquarie coverage universe;
- We take FY22 forecast EPS as 'normalised' EPS. We apply a 'haircut' of 15% to the FY22 EPS forecast.
- We then calculate a ratio of FY22 EPS (adjusted) to FY19 EPS. We screen for stocks with a ratio above 0.95 (which signifies earnings resilience)
- We sort by P/E based on FY22 adjusted earnings relative to the 3 year average of the 2-year forward P/E.
- The results are listed below. This is not a recommended list.

Investment Conclusions:

- The Australian market P/E is high versus history, but the valuation is a better guide for long term returns than short term performance.
- Our preferred "through the cycle" P/E measure has corrected dramatically through the coronavirus correction and is now well below average levels.
- The Australian market is characterized by an extreme level of valuation dispersion. Certain stocks/sectors (healthcare, technology, industrials) are trading at record premiums while others are trading at record discounts (financials, property, materials).
- Given the rally, we approach the equity market with some caution, but we remain buyer on weakness for a market that is in a consolidation phase, but which should be meaningfully higher in 12 months.
- We recommend investors raise any equity underweight positions back to at least neutral with excess cash drip feed into the market during periods of weakness.

Screening for value using P/Es based on 'normalised' earnings

		Current Share Price	Analyst Valuation	Upside to Valuation	Share Price YTD High	EPS 2019A	EPS 2022E	EPS* 2022E	EPS RATIO**	P/E 2020E	P/E* 2022E	P/E 3 yr ave.	P/E relative***
OZL	Oz Minerals	$8.66	$10.00	15.5%	$11.08	$51	$118	$100	1.98	20.7	8.6	14.7	-41%
GPT	GPT Group	$4.04	$4.81	19.1%	$6.39	$31	$35	$30	0.97	14.0	13.4	16.3	-17%
CLW	Charter Hall Long WALE REIT	$4.01	$5.50	37.2%	$5.97	$29	$35	$30	1.03	12.6	13.4	15.8	-15%
ALL	Aristocrat Leisure	$25.22	$32.00	26.9%	$38.23	$140	$187	$159	1.13	27.0	15.8	18.1	-13%
AZJ	Aurizon Holdings	$4.56	$5.52	21.1%	$5.70	$24	$31	$27	1.11	17.1	17.2	18.5	-7%
ASB	Austal	$3.03	$3.10	2.3%	$4.54	$17	$25	$21	1.23	13.6	14.1	14.8	-5%
SSM	Service Stream	$2.15	$3.05	41.9%	$2.85	$16	$19	$16	1.00	13.4	13.6	13.8	-1%
SDF	Steadfast Group	$2.93	$3.30	12.6%	$4.10	$14	$17	$15	1.01	18.8	20.1	19.9	1%
LLC	Lendlease Group	$11.14	$14.92	33.9%	$19.45	$82	$115	$97	1.18	11.8	11.4	11.2	2%
CHC	Charter Hall Group	$7.90	$9.31	17.8%	$14.40	$47	$54	$46	0.96	11.8	17.3	16.3	6%
CWY	Cleanaway Waste Management	$1.84	$2.30	25.0%	$2.43	$8	$9	$8	1.00	26.6	24.2	22.5	8%
IEL	IDP Education	$14.30	$15.05	5.2%	$25.17	$28	$49	$41	1.48	77.4	34.7	31.7	9%
JHX	James Hardie Industries	$21.54	$32.75	52.0%	$33.42	$68	$85	$72	1.05	17.4	19.2	17.5	10%
BXB	Brambles	$11.07	$12.35	11.6%	$13.42	$36	$43	$37	1.03	22.1	19.3	17.3	12%
IPH	IPH	$7.40	$9.60	29.7%	$10.34	$33	$44	$37	1.15	18.8	19.8	16.8	18%
CAR	Carsales.com	$14.27	$15.30	7.2%	$19.60	$54	$62	$53	0.97	33.6	27.1	21.5	26%
GMG	Goodman Group	$14.22	$14.01	-1.5%	$16.78	$52	$67	$57	1.10	25.0	25.1	19.5	28%
WOW	Woolworths Group	$35.16	$39.00	10.9%	$43.96	$134	$156	$132	0.99	27.1	26.6	20.2	31%
DMP	Domino's Pizza Enterprises	$57.90	$66.10	14.2%	$66.19	$165	$232	$197	1.20	31.8	29.4	21.8	35%
A2M	a2 Milk Company	$18.08	$20.50	13.4%	$19.23	$39	$70	$59	1.54	37.5	32.7	24.3	35%
IGO	IGO	$4.70	$5.50	17.0%	$7.11	$13	$28	$24	1.91	19.2	19.6	14.5	36%
BVS	Bravura Solutions	$4.63	$6.00	29.6%	$5.98	$15	$19	$16	1.06	28.2	28.9	20.5	41%

* 15% cut to 2022 EPS

** Ratio of FY22 EPS to FY19 EPS

** P/E 2022* relative to 3 yr average of 2-year forward P/E

Source: MWM Research, May 2020

Jason and the Investment Strategy Team

The report was finalised on 18 May 2020

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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