AUSTRALIA

Macro Strategy

BREXIT & Australia: what now?

Event

- Voters in the United Kingdom have voted to leave the European Union.

Outlook

- On top of all the problems the world is already dealing with, Brexit introduces another level of volatility and uncertainty to the equation. Whilst the referendum outcome delivers transparency in one sense, the arduous task of extracting the UK from the EU, with political and policy repercussions for both, lies ahead. We have no clear view on how that process will play out.
- The **risk premium for growth assets has just gone up further.** While bond yields will likely be lower (the Australian 10 year has fallen below our 2% forecast, and the vote outcome adds downside risk to our 1.90% call – see *Aussie Macro Outlook: If you can't beat them...*), the decline is not the same as the fall in yields over the past few months which was more of a controlled move which did not come with 'shock' event that muted the discount rate decline.
- **We don't think this will turn into a Lehman-like moment.** There are key differences between the Brexit vote outcome and the Lehman event. First, **policymakers are prepared. Both the ECB and BoE have contingency plans in place (in terms of adding additional liquidity) and the Fed has already used this risk as a basis for standing on the sidelines in the last meeting.**
- Secondly, the Brexit vote is not a liquidity-type event. Whilst pricing has shifted, many key rates, forwards and fixed income markets are still operating. There is no generalized uncertainty around bank balance sheets. These were key factors transmitted the Lehman event through real economic activity.
- Domestically the RBA retains reasonable firepower. But a decline in the A$ is the first buffer zone for the economy – as is happening. The potential for joint co-ordination across central banks has become an increasingly likely event. Heads of major global central banks were already scheduled to attend BIS meetings in Basel over the weekend. Markets have moved to price in just 8.5bp of further tightening by the Fed by June 2018. The appreciation of the JPY increases the likelihood of additional easing, as does the uncertainty in the Eurozone.
- From an asset perspective, we have more confidence in the directional skew to prices rather than levels. Macro developments, such as a lower GBP, stronger Yen, weaker A$, lower bond yields and lower equities (watch for risk that the USD gets a proper defensive bid), are an overhang to domestic events and impacts. The fundamental impact on earnings for Australia domestics, in our view, is more of a function of how changes play out over the next few months and whether confidence (consumer and business) takes a sustained hit.
- Against the riskier backdrop, what we would fear is a "hung" parliament that has limited flexibility to adapt its fiscal response. We are already worried about how optimistic bottom-up earnings estimates are for the Industrial universe (~11%) and this raises the risk level rather than reduces it via a potentially sharper fall in the A$. Against this backdrop, (*continued over...*)

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- (from prior page...) **we don't know where the bottom is given the number of variables at play, but the least exposed to these external and then potentially flow on impacts to domestic risks are the domestic utilities/infrastructure/telco yield space – Telstra, Transurban, Contact Energy, Sydney Airports.** Translation risk has risen for the UK/Euro exposed business models and hence **this does reduce the preference for GMG, LLC and WFD and raises the attractiveness of the pure domestic REIT yield plays such as GPT and SCG.** The banks are higher risk yield plays against a backdrop where funding costs are likely going to squeeze higher even if not unruly. Resources and industrials which are global growth sensitive are potentially higher earnings risk stocks even if markets reset quickly.
- The potential for elevated volatility over coming months raises the focus on balance sheet events. **We estimate that Australian corporates have around 8% of net debt maturing over the coming 12 months** (approximately $24bn of a total $305bn outside of the banks) with a similar amount maturing over a 24 month period. Materials account for nearly 20% of all debt coming due over the next two years. However, as a proportion of market cap it is no different from Energy and Industrials (~5%) and lower than both REITs and Staples (~7%).
- **Capital spending (Energy, Materials, Staples) accounts for the largest proportion of rollover debt with acquisitions & development (REITs) the second biggest projected use of funds.** At an aggregated level, we are less concerned with debt maturity profiles for REITs and Infrastructure and Utilities where we are relatively less concerned with declining collateral values, cash flows or earnings. Requirements for Consumer Staples are dominated by **WES** and **WOW** (store expansion, refurbs and supply chain improvement). We note **WES**' credit rating remains robust and its debt term profile well balanced, but **WOW** has no such buffer. Within Energy, we think they have managed capital requirements well given the speed and extent of oil price collapse. **STO** has the most concerning liquidity positions, but we see limited liquidity risk for **OSH** or **WPL.** Transport has a disproportionate debt maturity schedule relative to market cap driven by **AZJ** and **QUB** while Industrials (**BRS, SVW**) and Consumer Services (**CWN, SGR, TAH, TTS**) have relatively large issues coming due. (See *Australian Equity Strategy – Risky Business*)

Important disclosures:

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

Benchmark return is determined by long term nominal GDP growth plus 12 month forward market dividend yield

Macquarie – Asia/Europe
Outperform – expected return >+10%
Neutral – expected return from -10% to +10%
Underperform – expected return <-10%

Macquarie – South Africa
Outperform – expected return >+10%
Neutral – expected return from -10% to +10%
Underperform – expected return <-10%

Macquarie - Canada
Outperform – return >5% in excess of benchmark return
Neutral – return within 5% of benchmark return
Underperform – return >5% below benchmark return

Macquarie - USA
Outperform (Buy) – return >5% in excess of Russell 3000 index return
Neutral (Hold) – return within 5% of Russell 3000 index return
Underperform (Sell)– return >5% below Russell 3000 index return

Volatility index definition*

This is calculated from the volatility of historical price movements.

Very high–highest risk – Stock should be expected to move up or down 60–100% in a year – investors should be aware this stock is highly speculative.

High – stock should be expected to move up or down at least 40–60% in a year – investors should be aware this stock could be speculative.

Medium – stock should be expected to move up or down at least 30–40% in a year.

Low–medium – stock should be expected to move up or down at least 25–30% in a year.

Low – stock should be expected to move up or down at least 15–25% in a year.
* Applicable to Asia/Australian/NZ/Canada stocks only

Recommendations – 12 months
Note: Quant recommendations may differ from Fundamental Analyst recommendations

Financial definitions

All "Adjusted" data items have had the following adjustments made:
Added back: goodwill amortisation, provision for catastrophe reserves, IFRS derivatives & hedging, IFRS impairments & IFRS interest expense
Excluded: non recurring items, asset revals, property revals, appraisal value uplift, preference dividends & minority interests

EPS = adjusted net profit / efpowa*
ROA = adjusted ebit / average total assets
ROA Banks/Insurance = adjusted net profit /average total assets
ROE = adjusted net profit / average shareholders funds
Gross cashflow = adjusted net profit + depreciation
*equivalent fully paid ordinary weighted average number of shares

All Reported numbers for Australian/NZ listed stocks are modelled under IFRS (International Financial Reporting Standards).

Recommendation proportions – For quarter ending 31 March 2016

	AU/NZ	Asia	RSA	USA	CA	EUR	
Outperform	50.34%	59.09%	46.67%	44.76%	60.66%	46.12%	(for global coverage by Macquarie, 3.72% of stocks followed are investment banking clients)
Neutral	34.14%	25.66%	32.00%	49.90%	30.33%	35.10%	(for global coverage by Macquarie, 4.79% of stocks followed are investment banking clients)
Underperform	15.52%	15.26%	21.33%	5.33%	9.02%	18.78%	(for global coverage by Macquarie, 2.31% of stocks followed are investment banking clients)

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