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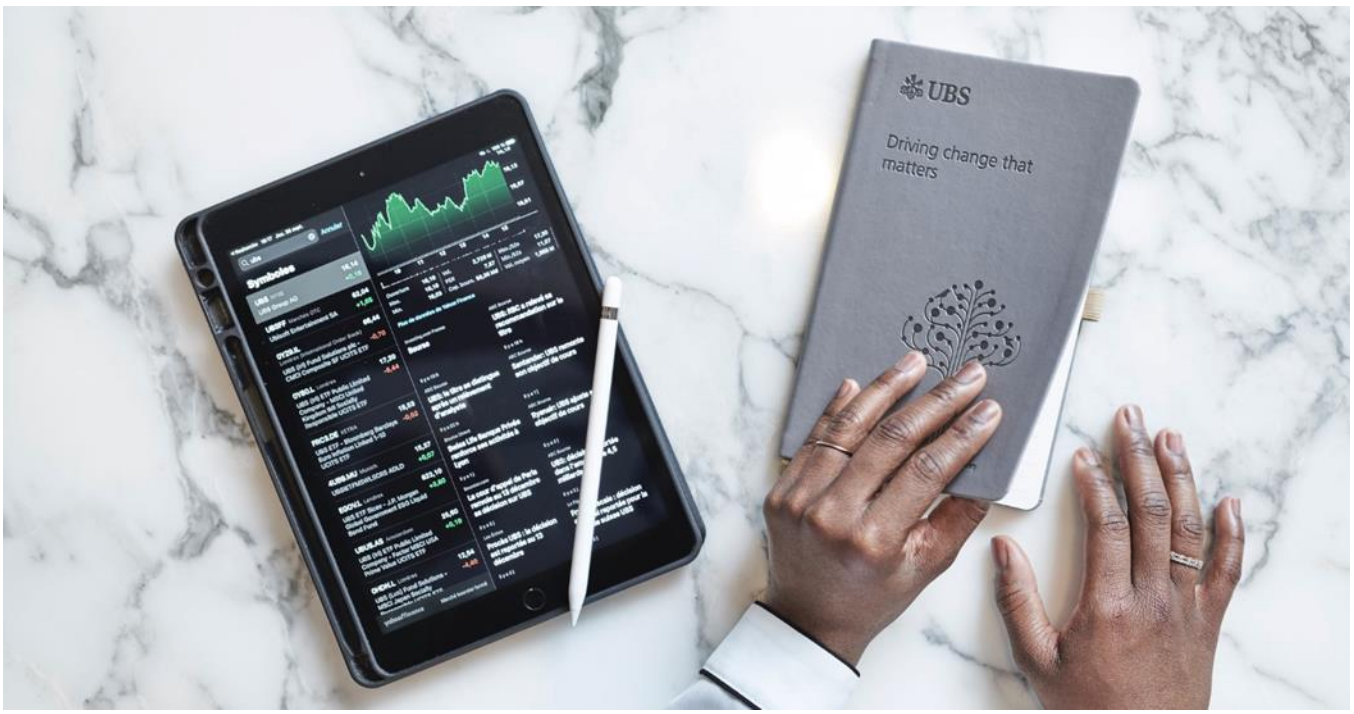
Australian Equities update:
Why are we so afraid of normal?



There has been an extreme bout of panic this year (ASX -11%, S&P 500 -19%) regarding the return of what appears to be a traditional business cycle (yes it still exists!) and key settings normalising.

With the glory years of low and falling interest rates (supplemented by a bit of QE) now over, financial markets are in a state of flux. This is notwithstanding the obvious inevitability that at some point interest rates would have to move upwards from zero!

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Commentators, many of whom just finished becoming experts on epidemiology, are now opining on the chance of a recession and discussing it as if it's a fatalistic event. It is worth noting the US had 12 recessions in the 20th century and still fared OK. Unfortunately there appears to be no sensible discussion about the duration or severity of a recession, instead just alarmist rhetoric.
While we won't attempt to call the business cycle, we do believe it's worth sharing a few simple facts with reference to the Australian market where we focus:

1. **In the event Australia slows down or heads into a recession, it would be doing so from an unbelievably strong starting point.** This rarely happens. The unemployment rate is at 3.5%, exports are booming (+38% y/y) and there is a massive pool of accumulated savings of some $350bn ($35k per/household);

2. **Interest rates have risen from nothing** (10bps) **to slightly more than nothing** (1.35%) and are likely to peak somewhere in the 2-3% range (RBA suggesting 2.5%, futures suggesting 3.5%). Interestingly, Australia's last four hiking cycles also averaged around 230bps of hikes (i.e. similar) and one out of every four resulted in a recession (early 1990s). Interest rate expectations – which are critical for financial markets – could well have already peaked;

3. **Inflation remains the central issue** (we never thought economists would be monitoring lettuce prices!), but again the lead indicators are suggesting a turn may have started and we are coming down from peak levels/peak fear. The Bloomberg commodity index is down 17% from the peak, freight has fallen by 32%, oil (WTI) has declined 19%, iron ore is down 59%, aluminium is down 39%, copper is down 26%, dairy prices are down 19%, coffee is down 22%, wheat has declined 38% and lumber is down 52%;

4. **Consumer debt is high** ($2.78tn) **but consumer net worth is higher** ($14.19tn). Gearing has come down over the last four years from a peak of 20.2% in 2018 and now stands at 16.4% (adjusting for mortgage offset account balances it is even lower);

5. **Mortgages rates are going up and servicing costs will go up**, but back to more normal levels (from a record low of 4.5% of disposable income in 1Q22 to 10.8% based on 3.25% RBA rate). Every 100bps is about $4.3bn and will likely adversely impact discretionary consumption (every 100bps would be an 1.5% hit to total consumption if all funded from there);

6. **Greater perspective on Australian housing is desperately needed.** The same experts who called for the collapse in mid-2020 have cut and paste their reports and are calling for a similar decline now (jumping over each other to win a prize for most bearish). It's worth noting even the consensus '15% crash' would take prices back to 2020/2021 levels.

Financial markets always look forward and often overreact. This sell off has put forward earnings multiples at 12.5-times, the lowest level since the GFC (one standard deviation below the long-term average). Clearly, broad based earnings downgrades are expected in August; a 20% downgrade would put the market at 'fair value', which may very well happen.

For what it's worth, we believe this feels like a forced slowdown in the economy and the panic that has ensued seems excessive. We are capitalising on the opportunity and stepping up at the epicentre of the panic to buy a number of quality cyclical and high growth business. We have established a position in Xero (XRO) which has halved and has enormous runway for growth (new markets, lifting average spend) and also increased positions in Carsales.com (CAR), Reliance Worldwide (RWC), and Nine Entertainment (NEC)

Data sourced from Bloomberg and YCM Research. All data at 18 Jul 2022.

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