Economic Insights

CommSec

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Key 2022 Sharemarket Themes

2022 – Not exactly like 2021, nor 2020.

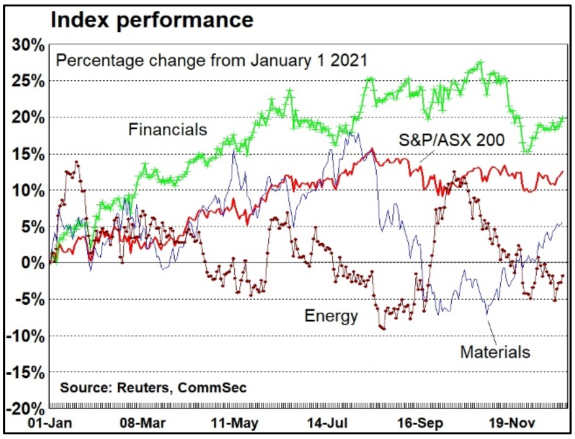
- **An increase in risk-averse sentiment in 2022 could decelerate passive investment gains.**
- **Supply chain disruptions and bottlenecks are expected to continue, causing downside risks to the Industrials, Consumer Discretionary and Consumer Staples sectors in 2022, even in 2023.**
- **Estimates suggest that ASX200 Consumer Discretionary retailers will improve margins in 2022, and companies in the Materials and Information Technology sectors are tipped to be highly profitable.**

Passive investment in 2022 – Indices, ETFs, diversified portfolios, where are they headed?

- Sharemarket performance in the coming calendar year will be contingent on the risk appetite of investors who have had to construct investment theses in a period where risks grew amidst broader economic expansion initiatives.
- An unprecedented amount of fiscal and monetary stimulus, sustained by investor optimism, has resulted in gains across global equity markets. As a result, global sharemarket indexes will start 2022 at, or near, all-time highs. The investable universe therefore - now present with fewer attractive opportunities - will cause investors to adopt an increasingly focused approach to portfolio construction. That is, more risk averse sentiment is expected.
- This therefore implies that as investors adopt a more bottom-up approach to investing - an approach which involves focusing on individual company factors - the strong performance of diversified portfolios and listed equity Exchange Traded Funds (ETFs) may be difficult to replicate in 2022. As at November 2021, listed equity ETF market-capitalisation was up 31.8 per cent on the prior year.
- Although a more idiosyncratic investment process may be adopted, investors may still need to pay close attention to systematic risks and themes that have emerged amidst a rather unique mix of risk-loving sentiments, eased fiscal and monetary policy, negative real interest rates, soaring company profits, dividends and buy-backs. These risks include semi-conductor shortages, supply chain disruptions, tightening of liquidity, fiscal policy drags, Covid-19 variant risks, and valuation risks.
- The capital markets space is also expected to normalise following the boom in mergers and acquisitions (M&A) in 2021. A total of A$12 billion in Initial Public Offering (IPO) capital was raised on the ASX in 2021, the most since at least 2014. Furthermore, there were more than 200 new quotations in 2021. But M&A activity could continue in 2022 with the potential for share price upside from takeover targets for investors.

Financials, Energy and Materials

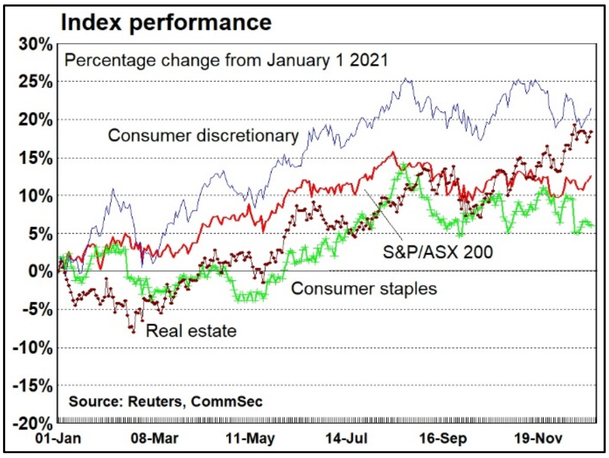
- In 2021, we saw these key sectors benefit from the global economic recovery as economies re-opened. However, this brings into question how much upside still lies ahead in 2022.
- **The Materials sector** in 2021 made historic movements, falling in September by as much as 12 per cent, consequently driving the index down 2.7 per cent and putting an end to an eleven-month consecutive gain. However, such movements are now in the rear-view mirror, including the 25.2 per cent slump in iron ore prices due



to the potential ramifications on iron-ore demand from the Evergrande property crisis. Some investors are keeping their powder dry after being exposed to the volatility generated by the Evergrande speculation. But others believe that the dynamics of the Chinese commodity market are at their worst, with the recent expansionary policy adopted by the government signalling a normalisation in iron ore price levels and improved construction activity in China.

- Investors are also turning their eyes towards **gold** as a hedge against inflation, and as a safe-haven asset amid periods of increased equity market volatility and higher liquidity. Key Aussie stocks include Newcrest Mining (NCM.ASX) and Evolution Mining (EVN.ASX).
- **Diversified miners** are also likely to benefit from their exposure to a variety of minerals, including those which provide exposure to late cycle growth, such as the battery market, including nickel and lithium. Furthermore, the global move towards more 'green-energy' will exist as a long-term structural change, and will continue to provide upside to miners that have exposure to such minerals.
- The **Financials sector** benefitted heavily in 2021 from the economic expansion and robust property activity, providing **banks** with robust balance sheets. This was reflected by the buy-back initiatives and dividend payouts announced in the previous fiscal year. And despite the forecast rate hikes, rational investors may continually to look favourably towards the expected strong dividend payouts of banks, as opposed to an investment in the yield curve.
- **Insurance companies** were caught in unfavourable circumstances following damaging weather events and other business interruption claims (on the onset of a volatile lockdown scenario). However, higher premiums now charged offer the potential for such general insurers to strengthen their balance sheets.
- **Insurance companies** will also benefit from the global inflation environment, in which increasing interest rates can support the yield offered on the short-term securities that insurance companies generally invest their floats.

Consumer Staples, Real Estate & Consumer Discretionary



- Excess savings and liquidity, increased risk appetite, combined with pent-up demand (as a result of stringent lockdowns throughout Australia) contributed to the record profits and growth experienced by **retailers** in 2021.
- The **retailing** industry can be separated into operators with purely online businesses, and those with a brick-and-mortar component.
- In 2021, investors were quick to price-in the impacts of the easing of restrictions on businesses. In some ways, this could be seen as the transfer of market share between brick-and-mortar retailers, purely online businesses and Omni channel retailers.
- The table on the right shows the share price performance (and the respective median) of purely online retailing businesses from both the 2021 highs, and from October 11, 2021 – which is when restrictions were removed - to December 24, 2021.

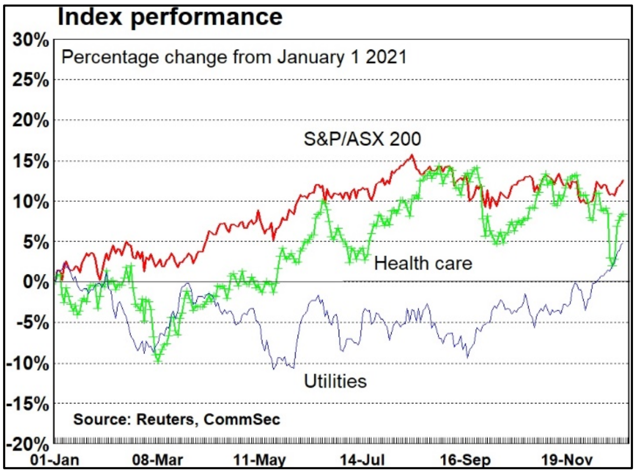
	From 2021 Highs	From 11th of Oct., 2021.
TPW	-29.9%	-16.5%
CTT	-24.2%	10.8%
KGN	-62.2%	-18.2%
RBL	-52.8%	-25.9%
MMM	-73.3%	-40.9%
ABY	-34.3%	-11.4%
BKG	-54.8%	-47.9%
MYD	-47.6%	1.4%
DW8	-74.4%	-27.5%
Median	-52.8%	-18.2%

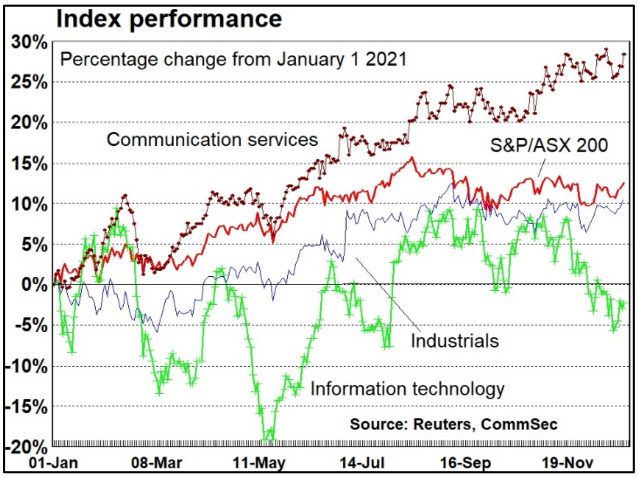
Source: Reuters, CommSec

- Purely online businesses, namely Redbubble (RBL.ASX) and Temple and Webster (TPW.ASX), both of which have no intention to declare dividends, aim to reinvest profits to sustain growth.
- With return on reinvested capital becoming increasingly difficult to sustain at high levels, and a broader thematic which supports customers buying in-store, the future performance of purely online businesses that are unwilling to distribute profits to shareholders, remains at risk.
- The brick-and-mortar stores, however, also have their own set of worries, with global logistics and supply chain disruptions serving to inflate shipping costs, causing downside pressure on operating profit margins.
- While a previous approach of picking retailers with adequate levels of inventory may have been sufficient to capitalise profits during the 'Santa Claus Rally', the approach may not work with the same success moving forward.
- Instead, a new approach, which emphasises the cash-flow ability of omni-retailers to re-stock inventory, or at a minimum, repay liabilities to their suppliers and debts to creditors, may be adopted. This of course, would be contingent on the performance of retailers across the Christmas period.

- **Automobile companies** are also at risk due to Aussie dollar headwinds (some automakers are heavily reliant on importing car parts, such as National Tyre & Wheel (NTD.ASX)), and forecast semiconductor shortages may continue to place downward pressure on car sales. Nonetheless, the performance of automobile companies in 2022 will be focused on outdoor activity, which is dependent on the severity of lockdowns, the unfamiliarity related to Omicron's potential, as well as further mutations of the Covid-19 virus.

Information Technology, Industrials, Communication Services, Utilities & Health Care





- **Industrial companies** were also impacted in 2021 by supply chain disruptions and the lack of raw materials. Labour shortages also added volatility to the operating environment.
- However, as announced by most industrial companies at their annual general meetings or when issuing trading updates, these problems are likely to persist into 2022, and will only ease slowly as bottlenecks become unblocked.
- Latest reports detail that the Californian ports are still suffering from backlogs, with some port operators suspecting that delays will last till 2023.
- **Information Technology** is closing the year on an extremely volatile note. Investors are struggling for reasons to support the sector in a period where valuations are high, hardware components are difficult to obtain due to semiconductor shortages, interest rates are forecast to increase, and shops are being closed due to staff isolations (latest Apple news).
- Valuations will demand a higher return on equity due to increased risk-free rates, and this will continue to remain as a key downside risk throughout 2022, especially in November 2022, which is when Commonwealth Bank (CBA) Group economists expect the Reserve Bank to start lifting interest rates from historic lows.

Valuations, Estimates & Other Themes:

- In 2021, 43.5 per cent of companies in the S&P/ASX200 finished at a discount to the forward (next 12 months) price-earnings ratio (PE) of 16.5 times (x).
- The forward PE ratio of 16.5x is at a 2.4 per cent discount to the trailing twelve months PE ratio of 16.9x, indicating that analysts estimate that the market is relatively expensive on an earnings valuation standpoint. That said, Aussie shares have a cheaper valuation to their global counterparts, with the US S&P 500 index trailing twelve months PE ratio of 28.9x sitting at a 26.8 per cent premium to the forward PE ratio of 22.8x, implying the potential for an Aussie catch-up rally.
- The estimates in the following table suggests that **retailers** will grow their profits at a rate quicker than their revenues, highlighting the decreased Covid-19 operating costs, and hence, an improvement in margins.
- **Information technology** also stands out as a strong profitable sector, however, a key risk to profitability would be the ability of companies to seek debt (to fund various research initiatives) at the historically low rates that are present now.
- Various cost cutting initiatives that companies are implementing, alongside a normalisation in labour availability and supply chain disruptions add to the growth of each sector within the ASX200.
- And **Industrials** sector shares could be in favour in 2022 due to the cyclical economic recovery.

- While Australian shares are faced with a scaling-back of monetary stimulus, fiscal policy could actually become more expansionary following the Federal Budget and Election, both due before May 2022. Already up to $16 billion in policy initiatives and policy stimulus will flow into the economy next year. Both also provide guidance as to which sectors of the market may outperform in 2022. Usually, government funding and support towards certain sectors (or companies), are key catalysts for investment decisions.

Median ASX200 Sector Analyst Estimate Growth FY22:

	Revenue	EBIT	NPAT
Consumer Discretionary	8.9%	10.5%	17.0%
Consumer Staples	5.8%	4.0%	16.7%
Materials	17.0%	28.7%	37.2%
Financials	11.6%	8.9%	18.9%
Information Technology	23.6%	29.0%	31.4%
Health Care	16.4%	20.6%	11.8%
Industrials	7.6%	17.4%	22.7%
Real Estate	0.6%	30.8%	-37.2%
Communication Services	11.2%	33.7%	23.3%
Energy	22.5%	63.6%	NA
Utilities	-1.4%	-1.4%	NA

Source: Reuters, CommSec

# of ASX200 Companies at a Discount to NTM Ratios

P/E	P/S	EV/EBITDA
130	143	155

NTM = Next Twelve Months; Forward Ratios.

Source: Reuters, CommSec

- In the upcoming February half-year reporting season, management discussion and analysis will be instrumental in obtaining perspectives in terms of how companies are navigating through the supply chain/semi-conductor risks. Rising corporate profits could still bolster share prices as the Aussie economy re-opens and economic growth strengthens. But inflationary pressures still present headwinds to company earnings, which are expected to grow at a median rate of 18.9 per cent (ASX 200 companies).
- The likely move higher in interest rates could benefit shares with a positive correlation to bond yields (recall that bond yields and interest rates are negatively correlated to bond prices). These companies include insurance companies such as Insurance Australia Group (IAG.ASX) or Suncorp Group (SUN.ASX), share registries, such as Computershare (CPU.ASX), or other money managers and brokerage firms. Aussie bondholders faced headwinds in 2021, and may continue to face similar challenges in 2022, as market interest rates rise, leading to capital losses, amid a scaling-back of central bank bond-buying programs.
- Persistent virus mutation risks, rising interest rates and elevated inflation may encourage investors back into defensive and value shares in 2022. Aussie shares could outperform their global counterparts in 2022, supported by stronger relative economic growth and higher relative dividend yields. CommSec expects the ASX 200 index to end 2022 between 7,600-7,800 points after finishing 2021 around 7,500 points.

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