



Investing for continuing recovery

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While the ongoing strength in equity markets is beginning to baffle a number of commentators, in our view we are seeing a typical recovery from a significant market downturn. The market performance since March 2009 is characteristic of recovery phases that have followed major market declines in past cycles.

However, while we still see further upside for the S&P/ASX300 Index, the market is probably in the final phase of the initial recovery rally. To date, the rise in the market has been driven solely by valuation expansion, which again is typical during the first phase of a recovery accompanied with low cyclical earnings. Currently the market is on 15 times 2010 earnings, but we think fair value in the market is still 15-20 per cent away at around 5000 points.

At some point investors will have to see evidence of improving earnings and dividends to justify higher levels on the index. In the next few weeks, investors will be preoccupied with reporting season, which is often a time for the market to pause. If the economic data coming out of the United States continues to show improvement and the US stock market continues to respond positively, the local market will get dragged higher regardless of how reporting season plays out.

At Platypus, we are now investing on the basis of the recovery continuing. While large-cap consumer discretionary stocks, such as David Jones and JB Hi-Fi, have been outstanding performers for us, the risk/return ratio is starting to diminish. We are therefore beginning to reinvest back into small caps, in particular consumables and industrials. Even if small-cap stocks haven't hit their absolute bottom, they are at very reasonable valuations and make an attractive investment option. We remain underweight in financial and materials, and we are still six months away from making a decision on whether to run an overweight position in the banks.

Looking at specific industry sectors, a few are currently of particular interest.

MATERIALS

Looking at the short term, there are a few uncertainties surrounding the materials sector. Some questions we think need to be answered before investing further in materials include: is the recent strong performance all due to restocking in China, will OECD restocking kick in at the right time, and how strong will the final demand be once the restocking is complete? In the medium term, however, the story looks more positive. Oil and copper prices have held up relatively well despite the crisis. We believe copper has the best fundamentals of the base metals at the moment and thus we switched out of Western Areas Nickel and into Oz Minerals. Rio Tinto is another company worth keeping an eye on – it has repaired its balance sheet and is leveraged to take advantage of recovering aluminium prices, a commodity currently out of favour. Sell-side earnings forecasts for Rio Tinto are currently well below the earnings level implied by current commodity spot prices. If commodity prices continue to remain strong this should then result in consensus earnings upgrades for the stock.

CONSUMER DISCRETIONARY

In our view, consumer confidence is a better predictor of retail sales than employment figures, and retail stocks continue to perform well. The cash handouts have been a factor in this, but the halving of the official cash rate has been the real source of the stimulus in this area. Furthermore, there is still ammunition in the monetary and fiscal tanks if needed. JB Hi-Fi continues to exceed expectations. In addition, David Jones and Super Cheap have robust business models and are taking share from competitors while still maintaining – if not improving – margins. Even though we have recently taken profits in the sector, our view on consumer discretionary stocks remains positive.

FINANCIALS

Flight to quality is the major driver in the financials sector, with banking revenue

still migrating into the hands of the top four, which will emerge from the downturn stronger than before. Earnings, dividends and capital will, however, continue to be impacted on by an evolving bad debt cycle. As the cycle draws closer to its maturity, a terrific opportunity will emerge in the sector. At this stage, we expect the 2010 fiscal year to be another subdued year for the banks, but for hockey-stick earnings recovery to develop in 2011. Timing the entry point to take advantage of the recovery in the 2011 fiscal year will be critical. In terms of performance and stability, Australia's top four banks are head and shoulders above their global peers.

Overall, we believe the 'crisis' part of the global financial crisis is now over. Obviously there are still a number of issues to play out, not least of which is re-regulation. Over the past 24 months, bad business practices have been continually exposed, which will impact negatively on ongoing sentiment. Re-regulation is the inevitable response. It will take some time – perhaps several years – before investment returns will get back to their pre-2007 levels.

The consensus view is we will experience a sub-par economic recovery, however, the resilience of the Australian economy continues to stun most commentators. The government's fiscal measures have worked more or less as intended, and consumer confidence has increased as interest rates have fallen. The Chinese economy has also continued to perform more strongly than some anticipated, responding dramatically to monetary and fiscal easing. Of particular importance to Australia is that Chinese imports of raw materials remain strong.

In Australia, retail sales growth is strong and leading indicators are improving. Most have now bounced back from historic lows although they remain relatively weak in absolute terms. The US economy appears to be stabilising and this recovery, along with consumer and business confidence, is crucial to an ongoing recovery. «

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