A Time For Optimism

20 August 2020 | Tim Carleton, Auscap Asset Management

The COVID-19 pandemic has provided many companies with complex problems to solve, created unparalleled levels of uncertainty in financial markets and made forecasting or interpreting financial results difficult to say the least. In this newsletter we discuss why we remain optimistic about Australian equities despite the challenging conditions.

The current reporting season is like none other before it. The COVID-19 pandemic has provided many companies with complex problems to solve, created unparalleled levels of uncertainty in financial markets and made forecasting or interpreting financial results challenging to say the least. Questions that remain around expected timeframes for a return to normality, the level of government support going forward, whether there will be a fiscal cliff and the possibility of further waves of infection are among a myriad of pressing concerns.

We find it useful at times of extreme uncertainty to acknowledge what we do not know. We can be vigilant in monitoring significant developments and understanding their likely impact on the companies we are invested in, but we are conscious that we do not know:

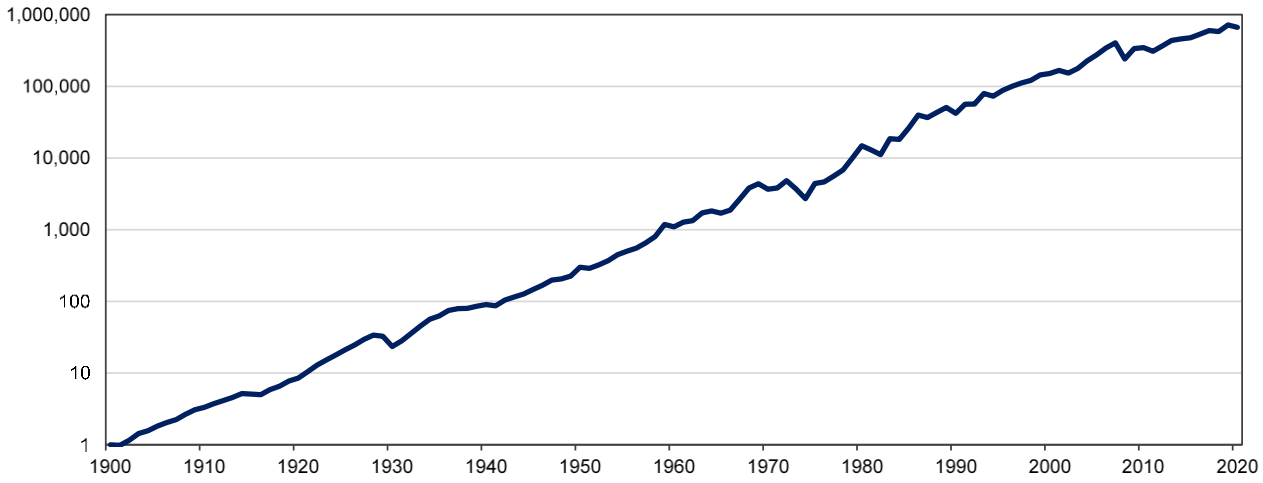
- How COVID-19 will play out over the coming days, week and months;
- What letter of the alphabet the economic recovery will look like;
- What new crises will emerge on a go-forward basis; or
- How the sharemarket or particular stocks will perform over any short term period.

So the question is how to invest in an environment of such uncertainty, where the range of short term outcomes is wide and will depend on events which are entirely unpredictable. Our response is to acknowledge these uncertainties and to then focus on what we do know.

Australia is a great place to invest

Over the last 100 years the Australian sharemarket has delivered a double digit annualised return, one of the best performances of any developed economy. We think it is extremely likely that Australia will continue to be a great place to invest on a go forward basis. This is a function of a multitude of factors. Australia has a growing population and a healthy demographic profile. As a stable capitalist based democracy there is the rule of law, a separation of powers, private property ownership, comprehensive and compulsory education and a system of taxation that encourages innovation but also protects the weakest members of society. Australia is resource-rich and geographically proximate to some of the fastest growing economies in the world. There is an independent central bank and a Federal Government which is in a strong relative fiscal position. We are confident that all of these elements will combine to continue to see Australia outperform most of its developed world peers for decades to come.

ASX All Ordinaries Accumulation Index since 1900 (log scale)

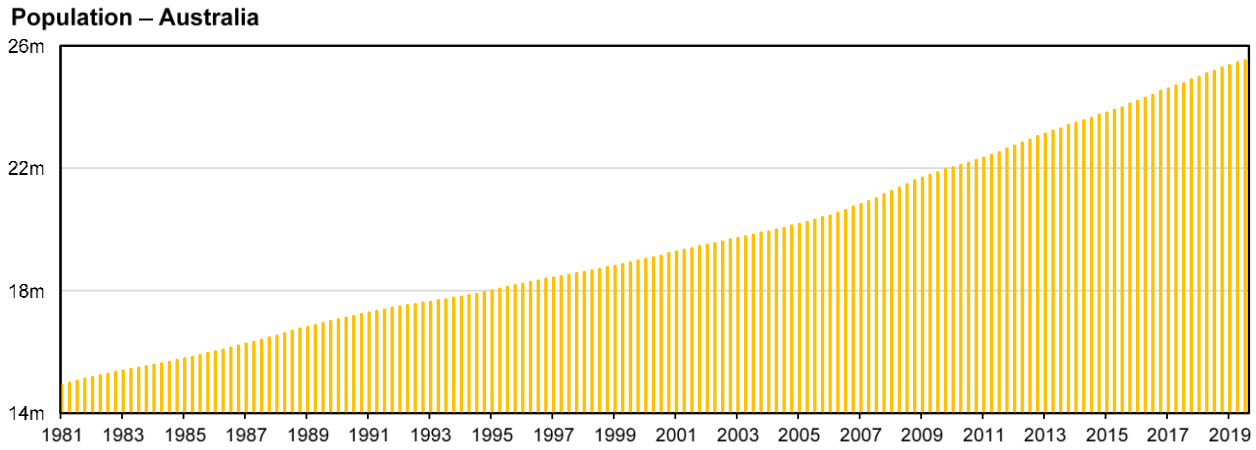


Source: MarketIndex.com.au, Iress, Auscap

Australia will continue to grow

There will be more Australians in ten years time than today. Australia's state capitals are consistently rated as some of the world's most liveable cities. National population growth has been strong, averaging an annual growth rate of 1.4% over the past three decades. Treasury forecasts that in 2021 population growth will remain positive at 0.6% despite the closure of international borders. If this crisis has demonstrated anything, it is that there is nowhere you would rather be living. Migration demand will most likely accelerate once international travel restrictions are eased. A rising population will drive long term growth

in the consumption of goods and services. That means there will be more couches and computers sold in ten years time than today, there will be more housing credit, there will be more insurance purchased, there will be more demand for space in our cities and suburbs, there will be plenty of housing construction and roads built, and there will be significant innovation.



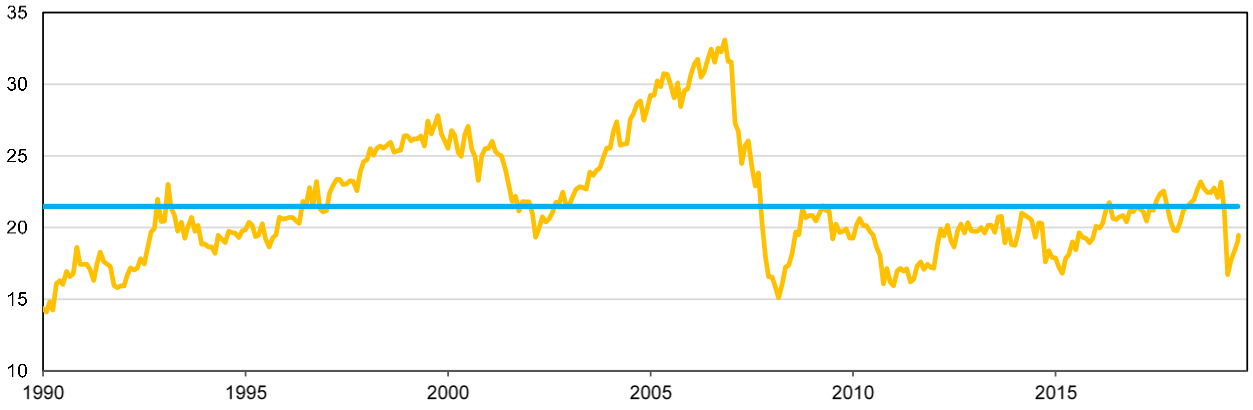
Source: Australian Bureau of Statistics, Auscap

Uncertainty creates opportunity

Abundant caution generally results in attractive investment opportunities. At the moment caution is significant. Cash holdings are significant. The All Ordinaries Index is 11% below its 2007 high made 13 years ago, despite GDP being more than 65% higher than what it was then, including the effect of the current recession. And broad stockmarket indicators suggest value is on offer.

The Shiller Cyclically Adjusted Price to Earnings Ratio is well below average.

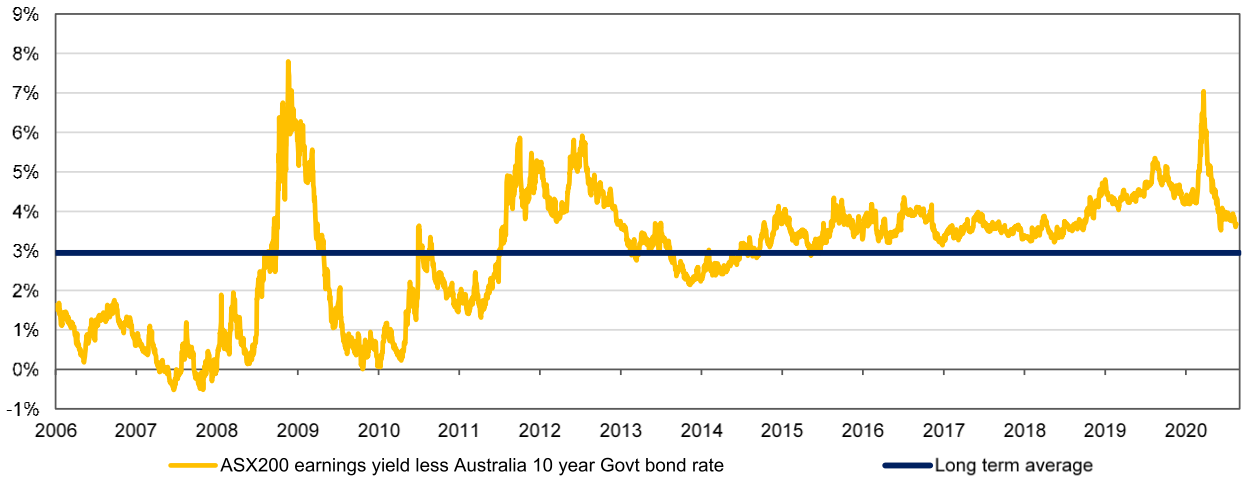
Shiller CAPE Ratio - Australia



Source: Bloomberg, Auscap

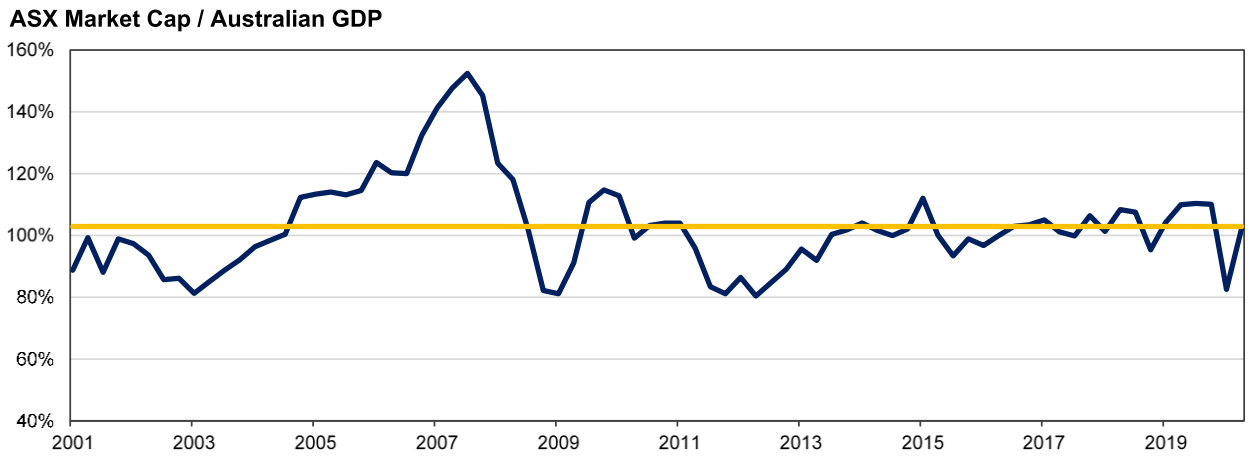
The implied risk premium you get from investing in equities remains elevated and above the long term average.

ASX200 Implied Equity Risk Premium



Source: Bloomberg, Auscap

And Australia's market capitalisation to GDP ratio is below the 20 year average, despite the negative impact of COVID-19 on GDP in the most recent quarter.



Source: Bloomberg, Auscap

These indicators suggest that there is value on offer within the market if one were to take a medium term horizon. Given we have little if any advantage in forecasting near term outcomes, taking a medium term view seems to be the most sensible path forward, acknowledging that the road back to normality will be bumpy, and there may be some permanent changes in behaviour. Albeit any behavioural changes are already appearing to be less significant than many thought only a few months back, with the converse true in a few instances.

In a crisis the best companies tend to demonstrate their superior qualities. In recent weeks, many of our portfolio companies such as Eagers Automotive, JB Hi-Fi, Mineral Resources, Nick Scali and Super Retail Group have updated the market with positive trading updates. Understanding what we do and do not know helps us focus on what we see as a key advantage, taking a medium term time horizon to invest in some of the best companies in the market which should benefit from positive long term economic prospects. We are confident that the companies in which we are invested are well positioned to recover and grow over the medium term.

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