HORIZON
INVESTMENT SOLUTIONS

August 2021 — Over the Horizon Market Commentary by David Offer

August was the 11th consecutive positive month for the Australian share market, with the All-Ordinaries Index gaining 159 points or 2.1% to close at 7,823 points. Since our last negative month, which was September 2020, we have seen the All-Ordinaries Index appreciate 28.5% and 33.6% with the inclusion of dividends. Even share market bulls would agree that we must surely be due for a breather in our share markets' ongoing upward trajectory.

Aiding a strong share market was a decent reporting season. The stand outs were our major iron ore miners including BHP, RIO Tinto, Fortescue Metals and Mineral Resources. All reported boom profits and paid record dividends. In most areas of our economy, companies benefited from the unparalleled support and stimulus programs of the Australian government. Most of the support was aimed at households, which collectively account for approximately 54% of all consumption within our national economy. Households also redirected funds normally spent on overseas travel, estimated to be worth as much as $60 billion per annum, towards domestic spending. Retailers such as Wesfarmers' Bunnings, JB HiFi and Harvey Norman typified the major beneficiaries of this consumption binge.

The sectors that struggled the most included travel, hospitality and tourism. However, as reflected in recently appreciating share prices, there is growing expectation that as Covid related restrictions eventually pass, many businesses in these sectors will see a rapid and positive reversal of fortunes.

As further evidence of a strong reporting season, Australia's largest 100 companies have now accumulated $27.2 billion in franking credits since the beginning of the pandemic in early 2020. In total, these companies now hold a combined $66.4 billion in franking credits. The largest franking credit balances are BHP with $19.2bn, Rio Tinto ($14.8bn), Fortescue Metals ($5.6bn), Commonwealth Bank ($3.7bn) and Westpac (3.4bn). CBA has already announced an off-market buyback, as has Woolworths, with the other four prime candidates to follow suit at a later date. Possible dates for a company to announce an off-market buyback include the day of the Annual General Meeting or when reporting interim profit results in February next year.

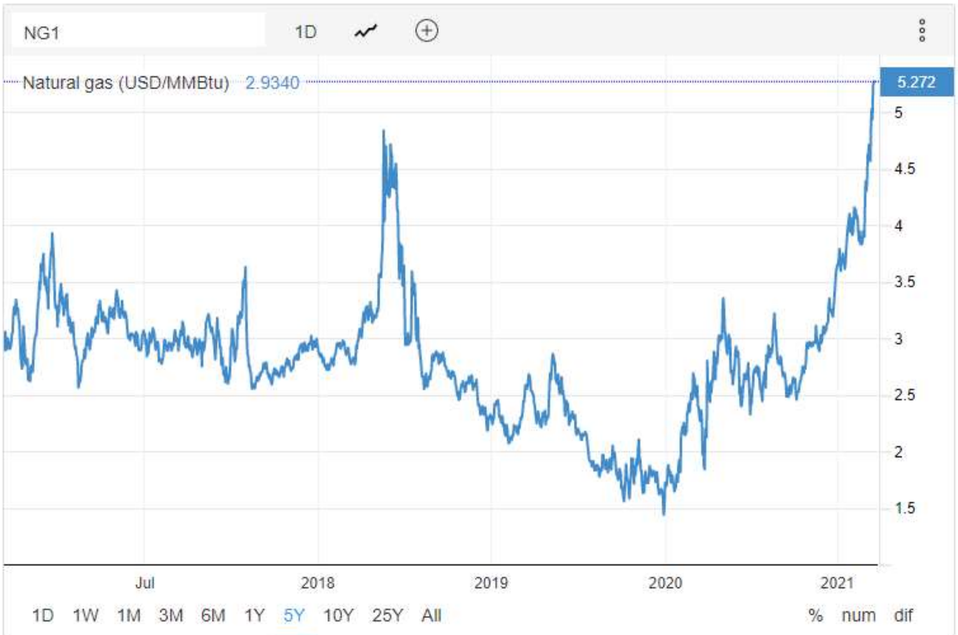
A dominate theme across all company results was ESG (Environmental, Social and Governance) reporting, with credentials often spelt out on the front page of profit announcements alongside reported results. Arguably the grand-daddy of all announcements was BHP announcing the jettisoning of its 'dirty' oil and gas assets to Woodside. BHP, in 'taking climate charge seriously', has arguably washed its hands of its responsibility for both the past and the future, with a new set of (Woodside) shareholders to soon be charged with the custodianship of these assets going forward.

Based on current energy prices, this may not be a bad outcome for Woodside shareholders. A lack of willingness to supply capital at a global level for carbon energy production is reducing the level of ongoing investment in the sector. However, carbon energy is still what is primarily used to keep the lights on and allow movement of people; even electric cars need power from somewhere. This is creating strong demand for traditional sources of carbon energy and correspondingly high prices. For example, the price of thermal coal, which is used for power generation, has surged in line with demand in preparation for the upcoming northern hemisphere winter. This has been compounded by a current shortage of wind generated power, with wind turbines in the North Sea generating less than 10% of their potential power output as they sit idle during an unusually calm autumn.

Thermal coal price per tonne

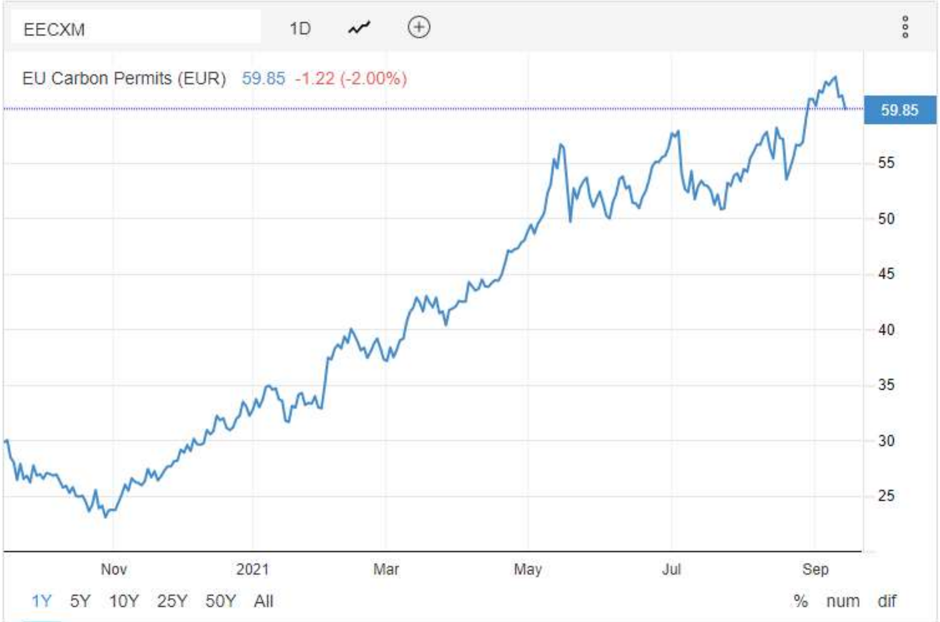
Similarly, the natural gas price has spiked with an increase in demand in Asia, Europe and, thanks to hurricane induced production cuts, also America.

Natural gas price (metric million British theral unit)



Interestingly, the cost of carbon credits in Europe is also rising, as energy companies are forced to purchase to offset the rising use of coal in power generation. (In Australia, the cost of a carbon credit, while rising in value, still sits at a material discount at just $20 a tonne.)

European carbon credit price



While the oil price is higher than pre Covid, the current demand in coal and LNG suggests that more upside in the oil price may be likely. Perhaps this may start to materialise in 2022 once air travel picks up as more countries open up post vaccinating against Covid.

Brent oil price

Despite current subdued share prices, we remain optimistic on oil and gas companies. We accept and welcome the transition to a low carbon future. However, approximately 7% of the world's oil and gas reserves are consumed per annum and the majority of these reserves will still need to be replaced. With a shortage of capital available to fund new discoveries and develop new reserves, we expect oil and gas prices to remain high going forward, even as the size of the overall industry contracts. Our current preference is **Oil Search** as the cheapest way to access the strong growth profile of a merged Santos / Oil Search entity. We are also comfortable with **Woodside** and **Origin**.

While the board of BHP congratulates themselves on their moralistic stance and box ticking acumen, they may be better served keeping an eye on the iron ore price. Thanks to Chinese steel production cuts, in less than 3 months, iron ore has fallen nearly 50% to $125 a tonne. While current pricing is still extremely profitable for BHP, they would still be making good money if the iron ore price halved again in price to $62.50 a tonne, the concentration towards iron ore is making BHP increasingly reliant on the policy directions of the Chinese Communist Party. Not a great outcome for our 'Big Australian'.

<u>Iron ore price</u>

Last month we mentioned a number of businesses that stand to recover strongly post Covid, some of which have since rallied strongly. Another Company that may similarly benefit from the upcoming easing of current East Coast lockdowns is building company **Boral**.

Boral was recently subject to a takeover attempt by Seven Group (Seven). Seven managed to acquire 66% of the Company through offering Boral shareholders $7.40 a share. Since the conclusion of the takevover, Boral has drifted back to around $6.00 a share. Thanks to asset sales, Boral may have up to $4.00 a share in surplus capital to return to shareholders over the next year or so. At a minimum, under the control of Seven, Boral will almost certainly buy back shares on market. This will reduce the number of shares on issue and indirectly increase Seven's shareholding in the Company. We view it as almost inevitable that Boral will be acquired in full by Seven at some point in the future. As such, Boral offers upside through a return to normal operations post Covid, future capital returns or share market buybacks as well as possible corporate activity. Having sold into the takeover at $7.40, we are happy to again start buying a part holding in Boral. We note that the during the recent takeover battle, the independent expert report by advisory firm Grant Samuel valued Boral shares at between $8.25 and $9.13.

Finally, NSW has now passed the 80% mark of people eligible to be vaccinated (16 years and older) with at least one jab. This suggests that by mid October approximately 85% of the eligible NSW population will be fully vaccinated. This is a commendable effort. With Victoria not far behind, come Christmas, we expect travel will once again be occurring freely between our two most populated states and with life largely back to normal *with people accepting Covid within the community*. If Mark Mcgowan intends to keep the WA border closed until April next year, expect another constitutional challenge to the High Court of Australia to soon be forthcoming. I would not back our Premier being successful this time round.

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