March 2022 — Over the Horizon Market Commentary by David Offer

March was a strong month for the Australian share market with the All-Ordinaries Index climbing over 6% to close at 7789 points. Gains were particularly strong in the bank and resource sectors as the market shunned global geopolitical concerns, strong domestic inflation and US inflation levels not seen since 1981.

Superficially, it would appear that the market is following its seasonal trend with history showing some months consistently performing better than others. Over a 12-month period, this pattern comprises of a reasonably buoyant July as new (predominately superannuation) money enters the market and year-end tax loss selling abates.

August, September and October tend to be choppy months as companies report full year results and go ex-dividend. From November through to January the market often rallies, usually on very light volume over the Christmas period. Perhaps this is because less money is required to move the market as many market participants are on holidays. Select buying then provides global fund managers with an opportunity to improve their year-end returns. February and early March can be a little choppy as companies provide their interim profit announcements and once again go ex-dividend. March and April tend to be the strongest months, with the market often drifting higher on relatively little company news.

Conversely, May tends to be the weakest month for the market. ‘Sell in May and go away’ is the mantra. This may be due to profit taking, as well as being the start of ‘confession season’. This is the time when companies that have bad news to report tend to do so well in advance of the end of the financial year to avoid providing unexpected nasty surprises to the market when they report their full year results. Confession season continues into June, which can also incur tax loss selling. This is where underperforming shares are often sold down further as investors offset gains on their winners to minimise tax.

As discussed in previous covering letters, Australia’s share market is increasingly concentrated on resources and bank shares. Resource shares have run strongly due to commodity prices spiking as a result of the war in Ukraine. Bank shares have performed strongly as the market expects upcoming interest rate rises will assist bank margins. While the cost to borrow money will rise in line with Central Bank interest rate rises, don’t expect interest paid to deposit holders to increase at the same rate. This is because banks are presently holding excess deposits. For example, Commonwealth Bank has 73% of its lending funded by deposits compared to just 55% in 2008.

Aside from bank and resource shares, many industrial shares still appear to be attractively priced with promising prospects. Many of these shares already feature in portfolios and include Seven Group, Tassal, Brambles, Amcor, Lend Lease and United Malt. Two shares that we are buying with renewed focus are Perpetual and Suncorp Metway.

Perpetual is an active value manager that has enjoyed recent strong investment performance which is translating to increased fund inflows and revenue. It is also Australia’s major provider of trustee services. With a strong balance sheet, Perpetual has been making acquisitions which should boost earnings in future years as it widens its product range and achieves improved economies of scale. The Company has recently made a takeover offer for fellow fund manager Pendal. This appears to be depressing its share price; at $31.50 the Company is well off recent highs of $42.00 last September. Perpetual is on a forecast Price Earnings Ratio of 12.5 times and dividend yield in excess of 6% fully franked. Strong growth in both profits and dividends are expected to continue in subsequent years.

Suncorp Metway's business is split equally between banking and insurance. On a valuation basis, the Company is trading at a discount to the major banks and insurance companies with recent share price weakness stemming from concerns over increased insurance claims this year due to the East Coast floods. The last few years have been an unquestionably difficult period for insurance companies. However, Suncorp has considerable reinsurance in place and this should shelter the Company from excessive insurance claims. While reinsurance premiums will be higher in future years, this should be more than offset by rising insurance premium income. Like banks, insurance businesses perform well during rising interest rate periods as a considerable component of revenue has historically been investment and interest income earned on insurance premiums held until they are paid out. Suncorp is on a prospective Price Earnings Ratio of 13 times and dividend yield in excess of 6% fully franked and, like Perpetual, should see a continuation in growth in subsequent years.

As we head into May and a traditionally a weaker period of the market, a potential catalyst for a market breather could be the largely assumed upcoming interest rate rise in June. If this eventuates, it would be the first interest rate rise since November 2010, an unprecedented period of time for interest rates to track down. The expected June rate rise has been based on Reserve Bank (RBA) Governor Philip Lowe recently stating the RBA is no longer "prepared to be patient". The RBA is instead now on a watching brief for a rate rise with buoyant consumer price and wage growth figures to be the catalyst to start to 'normalise' monetary policy. If a rate rise eventuates as predicted in June, this will be an embarrassing reversal for Philip Lowe, who had repeatedly stated there would be no interest rate rises before 2024. The bond market is assuming future rate rises with Australian 10-year government bonds now yielding in excess of 3% for the first time since 2014.

Notwithstanding any potential short-term weakness, we will not be surprised if the market goes up once the interest rate rise occurs as the share market tends to 'sell on rumour' and 'buy on fact' and there has been ample time to factor in the inevitable.

We suspect that the share market will be able to accommodate quite a number of interest rate rises in Australia given interest rates are just 0.1% and negative in real terms. For example, eight 0.25% interest rate rises would still only see the official interest rate at 2.1%, an extremely low level by historical standards.

Our office wishes everyone an enjoyable Easter break.

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