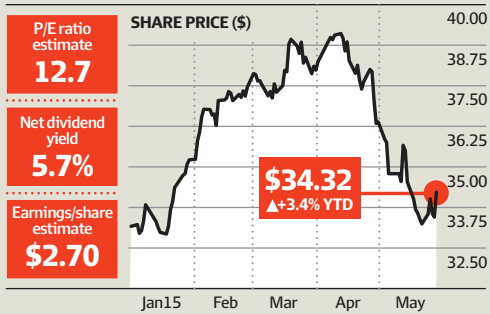


## NAB

### Market snapshot



SOURCE: BLOOMBERG



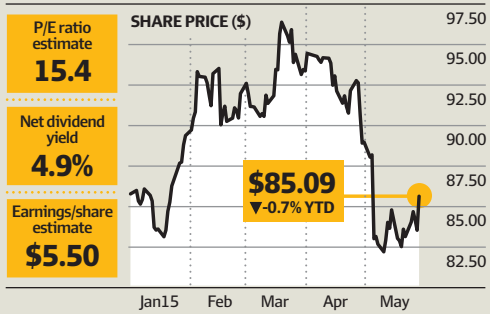
**UBS** ("neutral") We believe that NAB made the difficult but correct decision to announce a UK demerger/IPO (despite the required £1.7 billion [\$3.4 billion] provision for conduct) and strengthen its balance sheet. Since Andrew Thorburn has taken over as chief executive in August last year, he has restructured his executive team, written down and re-provisioned the book, announced an exit path from the UK and raised

equity. The market has rewarded NAB, being the best-performing major [in the] year to date. However, NAB is no longer cheap. **Goldman Sachs** "neutral" There is upside in accelerated recovery in domestic business banking franchise, recovery in business lending. There is downside in the failure to successfully execute on various capital initiatives announced at the first-half 2015 result,

deterioration in asset quality. **Deutsche Bank** ("hold") While it is encouraging to see NAB de-risking its business by exiting the United Kingdom and significantly bolstering its capital position, the steps taken appear to have delivered limited valuation upside, with much of the benefit of the UK demerger eaten away by the £1.7 billion capital charge for conduct risk. We agree that the core franchises should re-rate.

## CBA

### Market snapshot



SOURCE: BLOOMBERG



**UBS** ("neutral") CBA provided a soft trading update for the third quarter of 2015 (to March). Although revenue growth was above peers, underlying trends were weak. Net interest margin pressure is building, particularly in mortgages, while revenue continues to be supported by trading income. Costs rose sharply, with regulatory costs called out. Jaws [a ratio which compares income growth to expenses

growth] were negative. **Goldman Sachs** ("sell") There is upside in stronger-than-peer margin performance given funding flexibility, leverage to recovering equity markets and leveraging technology advantage. **Deutsche Bank** ("hold") CBA's third-quarter update was disappointing, with cash earnings around 5 per cent below the quarterly average of the first half of 2015 on higher costs. While some of

the costs are likely one-off in nature (eg, customer remediation), the bulk appear recurring and this has driven down grades to outer-year forecasts of almost 3 per cent. Repricing action by CBA shows it is willing to take steps to offset margin pressure, however the benefit looks small at this stage. While recent heavy share price falls have seen better value emerge in the sector, we remain on a hold on CBA.

There will, however, be capital losses too, but if the insurance company owns shorter dated bonds, the losses are kept to a minimum.

The other benefit of a hike in interest rates is it reduces an insurer's liabilities. Insurers have to give an estimate of how much they might have to pay out in claims and as interest rates rise, the liability is lower in present value terms because the discount rate goes up.

Two stocks that Clime recommends are Berkshire Hathaway and American Insurance Group.

For local investors, if rates do rise it puts pressure on the "hunt for yield" strategy that has been so popular and successful over the past few years. Those yield stocks have also helped to keep valuations in check as they normally trade with a lower forward price earnings ratio.

Take away the banks and financials and the accompanying graph shows that the forward P/E of the top 100 industrial firms is 18.4 times earnings.

That's down from a peak of 19.5 times earlier this year, but still not cheap.

If interest rates and bond yields head higher, any further re-rating of the market will probably have to come from the

earnings side of the P/E rather than the price side.

According to analysts at Macquarie, that means going after stocks that offer sustainable, above-average earnings growth.

In their model portfolio, they maintain an overweight exposure to offshore growth stocks but have trimmed their holdings in Brambles and Computershare.

What they have also done is increase their exposure to some domestic cyclicals on the back of the good reception consumers have given the federal budget.

The broker favours Tattersalls and carsales.com, rather than realestate.com, while holdings in Seek, JB Hi-Fi, Lend Lease and FlightCentre have been increased.

Companies that get a fair chunk of their earnings offshore are also a focus for Morgan Stanley.

The broker is very bearish towards the Australian dollar and this week it fell back under US77¢ on some very disappointing business investment numbers.

Another rate cut to 1.75 per cent by the Reserve Bank of Australia is also expected so the broker remains interested in stocks like Macquarie Group, James Hardie, Ansell, Resmed and Goodman Group.

# Changing dynamics call for a new strategy

## Big picture

Karen Maley



Changing market dynamics mean that retail investors will no longer be able to reap the same handsome returns from owning low-risk blue-chip stocks that they've enjoyed in the past four years, says BT Investment Management's head of equity strategies, Crispin Murray.

Murray points out that the last market phase – which began in September 2011 when the market first began to price in cuts in local interest rates – has been characterised by a major re-rating of the market (in which average P/E ratios have climbed from 11 to 16) and a shift into high-yielding and defensive stocks as well as those benefiting from a falling Australian dollar.

"If, back in September 2011, you had invested in the most seven popular retail shares in the market – the four big banks, Telstra, Wesfarmers and Woolworths – you would have done extremely well," says Murray. "That portfolio of stocks has outperformed the overall market by around 8 per cent a year, so it's been a good time for investors in the popular blue chips."

But, he warns, the market is now entering a more ambiguous phase. Although central banks in Europe and Japan are still running aggressive quantitative easing programs, the United States is beginning to move in a different direction.

"I think we're seeing different behaviour in the market, and it's important for investors to be aware that what has worked for the past three-and-a-half or four years is not necessarily the right strategy going forward."

He warns that as the market enters a new phase, investors will need to be more stock-sensitive and invest in companies outside the ASX Top 20.

They will also need to pay greater attention to the quality of the company's management, its ability to execute its strategy and whether it is at risk (or looking at fresh opportunities) from disruptive forces.

"The market is likely to deliver returns in the mid-single digits. It's not a bad market, but it is going to be much more difficult for investors to make sure they are in the right stocks."

Murray points to a growing number of disruptive forces, both for industries and for individual stocks, as a result of technological and demographic changes as well as growing regulations.

He explains: "Woolworths is a classic example of a stock which was the bluest of blue chips. But it now faces disruption from discount supermarkets, such as Aldi and Costco, which have come into this market at a time where there is much more transparency when it comes to prices."

Murray advises investors to be on the lookout for turnaround situations – either as a result of a company's own efforts or from improvements in the cyclical outlook for particular industries.

"For instance, we invested in Qantas at a time when it was caught in a capacity battle

with Virgin and its credit rating was being downgraded, and many in the market had almost written the company off which was reflected in its share price," he says.

"But the company took some hard decisions, realigning its cost structure to improve its competitiveness, and at the same time both Virgin and Qantas started pulling back on new capacity, which allowed supply and demand to rebalance."

"This change in industry dynamics, along with the reduction in costs, means that the airline is on track to reduce debt by \$1 billion this financial year. As a result of this de-risking, the company is much more attractive to investors, and its share price has rebounded strongly."

Murray is also enthusiastic about the outlook for Macquarie Group.

"Macquarie has done well in the last couple of years, but we feel there is more opportunity there. The investment bank has re-positioned itself, shifting its business model away from transactions and more towards recurring annuity-style income streams – from their fund management, leasing and mortgage lending businesses – and this has given it a greater confidence in terms of its ability to deliver earnings."

"They've also reinforced the group's balance sheet strength, increasing capital and putting in place more secure funding – both from deposits and longer-term borrowings. The material improvement in the quality of

*It's not a bad market, but it is going to be much more difficult.*

Crispin Murray, BT Investment

that business is reflected in the share price, but we think there will be further tailwinds as Macquarie's large Asian capital markets business benefits from the tie-up between the Hong Kong and Chinese share markets."

But Murray is more circumspect on the outlook for Australia's miners.

"We feel that Chinese growth is slowing and will continue to slow, and that it will be driven more by light industry and, to a lesser extent, consumption. The industry mix in China is changing, with Beijing encouraging private investment in industries such as technology and healthcare, while the state-owned enterprises are finding that their access to cheap funding is gradually being wound back."

This, he says, will impact the iron ore market – with the price likely to fluctuate between \$US45 and \$US60 a tonne – with second- and third-tier producers likely to come back into the market when the price rises towards the higher end of the range.

"So we look like we're in for a long period of consolidation, with life for the big iron ore companies OK but not exciting."

But there are other opportunities in the resources sector. "South32, the BHP spin-off, is interesting because it has a good balance sheet with low gearing, and it has the potential to take some costs out, and invest capital to extend the life of its mines," he adds.



Crispin Murray: fewer 'handsome returns'. PHOTO: DOMINIC LORRIMER