17 June 2020

EL&C Baillieu

Taking Stock

Major Markets	Last Price	WRR %	MRR %	YRR %
S&P/ASX 200	5942.3	-3.4	9.9	-9.0
XJO 40 Financials	4850.0	-5.5	16.6	-22.5
XJO 15 Materials	13405.4	-1.7	11.4	-2.2
XJO 20 Industrial	5933.6	-4.1	9.7	-11.5
AUD/USD	0.6896	-1.5	7.5	0.6
Bank Bill 90 Day	0.1	0.0	0.0	-92.3
S&P 500 Index	3124.7	-2.1	9.1	8.1
FTSE 100 Index	6242.8	-1.4	7.6	-15.1
iShares Europe	40.7	-3.4	13.3	-4.7
Shanghai Comp	2931.7	-0.4	2.2	1.5
SPOT GOLD	1726.5	-0.7	-0.8	28.9
WTI Spot	37.9	-3.0	27.2	-27.0

Movers and Shakers				
Healius (HLS)	3.11	19.6	29.0	-1.9
Appen (APX)	31.18	7.4	8.2	20.4
Newcrest Min. (NCM)	30.44	7.1	0.7	1.7
Nextdc (NXT)	9.50	7.0	1.5	41.2
Clinuvel Phar. (CUV)	25.00	5.7	15.9	-31.5
Pilbara Min (PLS)	0.28	-22.2	14.3	-55.9
Mayne Pharm. (MYX)	0.385	-18.1	-9.4	-26.0
Credit Corp (CCP)	16.96	-16.7	21.8	-34.0
Flight Centre (FLT)	14.10	-16.3	41.0	-62.0
Corp Travel (CTD)	12.42	-15.0	17.9	-45.3

WRR: Weekly Rolling Returns
YRR: Yearly Rolling Returns
MRR: Monthly Rolling Returns

The authors of this report do not hold shares in any of the above-mentioned stocks.

On the Wires

US retail sales rebound 17.7% in May
New wave of COVID-19 infections hits some US states
Economic concerns weigh on European stocks
Federal Reserve Chairman signals rates won't be raised through 2022
OECD warns that the global economy could contract by 6% this year

Banks providing value despite challenges

To say it has been a volatile few months for the market would be an understatement. It has been no different for Australia's major banks, with a c.40% COVID-19 induced fall in February/March eventually followed by a c.30% rally which finished on June 9, which was then followed by a c.10% drop in the subsequent four trading sessions.

As has been the case throughout this volatile period, we are at an interesting juncture when it comes to discussing the big four banks. The market certainly believed there was value prior to and during the sharp bounce that commenced in late May, but does value remain and if so, which bank shares should we be buying?

In the aftermath of what was a tough reporting season for the banks – mainly because it is a difficult time to be assessing the future (especially when it comes to bad debt provisioning) due to the coronavirus pandemic and its impact on global economies – our view was that a V-shaped recovery meant we preferred those that looked cheapest from a valuation perspective, while a U-shaped recovery meant we preferred those banks that were best capitalised and best provisioned for loan losses.

With regards to the latter, WBC and CBA remain clear stand outs for us as, from a capital preservation view, being residential mortgage banks, they come through the provisioning exercise looking in good shape. ANZ and NAB, on the other hand, have a larger concentration of their business on the currently more vulnerable small and medium enterprise segment.

However, from a valuation perspective, our order of preference is WBC, ANZ and NAB, with CBA bringing up the rear despite our view it is the quality and premium play.

Looking at overall price to earnings (P/E), the big four banks on average are trading in line with their long-term average of 12.2x based on forward earnings forecasts.

Meanwhile, based on consensus forecasts, Australia's banks are yielding below their long-term average of 6.5%. In saying this, yields remain considerably above bond yields, despite the recent share price rally. Earnings will dictate dividends and right now that is the big if, with so many questions to be left unanswered until after JobKeeper finishes.

Regarding the all-important price-to-book level, it remains our primary determinant of our price targets given uncertainty around JobKeeper and repayment holiday roll-off.

In terms of the key drivers of bank returns for shareholders, we know loan growth is flat, while reporting season revealed that net interest margins held up reasonably well, there is some softness in non-interest margins and costs are generally flat across the board, ignoring the residual remediation costs from the Hayne royal commission and Westpac's provision of $900m for AUSTRAC.

Essentially, in the current environment, the Australian banks are having to weigh the combined effect of the economic downturn, the ultimate cessation of the JobKeeper program and how long customers remain on loan holidays, and with this being an earnings event and not a balance sheet one, and with all but CBA still trading below book value, we remain constructive on the sector.

CBA and WBC are the most conservatively positioned, while, in order, WBC, ANZ and NAB offer the most in valuation terms. WBC is on top in terms of sector preference, with the caveat being that the AUSTRAC liability doesn't come in higher than the $900m figure provided.

As always, you should speak to your adviser about any of the above.