Macro focus

What's king; the pick of stocks, bonds and cash

Mark Story - July03, 2008

Given the volatility in share prices since the market tanked from its 6851 point November high, inflation at a 16 year high (of 4.25%), earnings downgrades, and record high oil prices, nervy investors can be forgiven for asking: What's the lesser of three evils cash, shares or bonds?

If the popularity of deposit accounts is any proxy, cash remains king of the asset classes with over 50% of all inflow from super and non-super currently being directed towards cash options.

But there's danger in prolonging this love-affair now that the Reserve Bank's next move looks to be a rate cut. With cash rates on a downward trajectory, the first shoe to drop will be bonds. Elevated bond yields and a likely rate cut early in 2009 bode well for bonds. But Nick Bishop, from Aberdeen Asset Management's fixed income team recommends investors pre-empt the curve by at least a quarter. "You don't want to be in cash when interest rates fall," warns Bishop. "The advantage of moving out of cash into bonds is a high quality 9-10% versus 8% in cash, plus the prospect of 2-3% capital gains later on."

Off radar

So with the S&P/ASX 200 Index down 15.4% since January, and further weakness expected before rallying sharply by year's-end, what sectors will best weather current market conditions? Stocks directly wired to a slowing domestic economy, including cyclicals like airlines, transport, infrastructure and listed property trusts (LPTs) that have followed earnings downgrades with major cut to distributions look decidedly unloved. Within the current bear market, Aberdeen's head of Australian equities, Mark Daniels says investors should be searching for defensive stocks across all sectors with diverse assets/earnings and quality management. He also warns investors against stocks with uncomfortably high debt levels which unlike a year ago include balance sheets with over 25-30% gearing.

Citi Smith Barney's Justin O'Brien says stocks regarded as highly defensive 12 months ago look more compelling while those needing aggressive refinancing or exposed to rising borrowing costs have been downgraded.

That's what he says 'safe and boring stocks' like Telstra (14X P:E and 6.5% yield) look attractive by default. "With the all the bad news already in Telstra's share price, the real downside is regulatory risk," says O'Brien.

At face value, major banks with P/Es of between 10-12X, look primed to outperform non-financials. Daniels' standout financials include, ANZ, Westpac, CBA and QBE Insurance, and despite earnings downgrades he expects them to deliver dividends of around 6%.

But MLC investment strategist, Brian Parker claims the argument for buying banks has fundamentally changed. He says the era of lower growth means dividend yields will become a more significant component of returns. Not only will banks struggle to repeat past performances, he says the risk of further bad debts has made investors wary.

On radar

While the commodities super-cycle looks unstoppable, growing speculation suggests only a handful of large-caps are long-term beneficiaries. Shane Oliver, chief economist With AMP Capital Investors says with share prices running ahead of earnings estimates, commodity-based stocks look vulnerable to short-term correction.

And according to PricewaterhouseCoopers' Tim Goldsmith, declining margins caused by rising costs, procurement constraints, power shortages, plus ongoing skill shortfalls make the future challenging for mid-tier miners.

That's why Andrew Muir resources analyst with Hartleys recommends diversified large-caps in or near production, especially within iron ore and gold. Beyond bellwethers, BHP Billiton and Rio Tinto, he favours Atlas Iron and emerging gold producer, Avoca Resources which both enter production in 2008.

While current gold prices are expected to remain intact for the interim, Muir expects iron ore to stay high for the next one to three years, and a mid-term oil price of US$90/barrel. "Diversified producers can expect increased volume in iron ore to offset weakness in copper (and strengthening A$), while mid-tier miners exposed to base metals will experience margin-squeeze as prices contract," says Muir.

On the energy front, O'Brien favours Woodside, Oil Search and Santos which he says looks most undervalued, relative to his target price of $28.95. Looking equally undervalued, based on his target price of $5.74 is coal seam gas producer, Arrow Energy.

With the price of phosphate having tripled, O'Brien's favoured agri-stock is chemical manufacturer, Incitec Pivot. He also fancies fertilizer/explosives company, Orica which trades on a P/E of 14X and 4.1% yield.

Due to strong market positioning, he also expects healthcare stocks, CSL, Sonic Healthcare and Cochlear to continue outperforming. And while deteriorating consumer spending has seen a sell-off in retail and consumer stocks, Daniels likes the strong defensive characteristics of Woolworths, which having shed 27% of its share price this year still expects to deliver 23% net profit growth. He also favours Lion Nathan, Billabong and JB Hi-Fi which recently upgraded its full-year profit.

On the small-cap front, he fancies funeral operator, InvoCare Limited which delivered a 14.6% full-year 2007 profit increase from higher death numbers, and new acquisitions. But if there's one stock all investors want to own, O'Brien says it's got to be BHP Billiton due to its exposure to the enduring coal/iron ore story, courtesy of insatiable demand from China and India.

What's in	What's out	Key stocks
Cash* Bonds Resource stocks in production Stocks servicing mining/agriculture Defensive stocks Net importers paying in US$	Transport Housing Utilities LPTs Airlines Infrastructure Highly geared co's Exporters paid in US$	BHP Billiton, Rio Tinto, Atlas Iron, Avoca Resources Woodside, Oil Search, Santos, Arrow Energy, Telstra, Woolworths, Lion Nathan, Billabong, JB Hi-Fi, ANZ, Westpac, CBA, QBE, Incitec Pivot, Orica, InvoCare, Comtel.

*Near-term rotation from cash to bonds expected

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