SWAEF Commentary: Banking and Commodity Options Amidst Situational Awareness

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Strength in the Australian equity market in July reflected strength in the banking sector, notwithstanding increasing pressures on earnings growth and high starting multiples. Earnings growth in the US market are high and broad based; in contrast, the local market will struggle to produce earnings growth outside of the commodities exposed names. Whilst productivity is the answer for value creation at a national and corporate level, little enthusiasm is currently shown for following this path at either level.

Market Review

It wasn't just at the World Cup where the UK outperformed Australia during July. Australian performance was very strong, with the equity market reaching record highs and in the process outperforming most major equity markets in the world, with the notable exception of the UK. Couldn't bring it home in football, again, but the investment Gods gave them a month atop the leaderboard for global equity indices to salve the pain. Locally, the major theme driving performance during the month was the performance of the banking sector, which constituted all of the net market gain. Despite ongoing poor performance in the US, the healthcare sector locally also did well during July, being one of three major global themes which permeated the local market during the month. The increase in global bond yields, with Australian 10-year bonds now yielding 5%, and the resumption of the energy trade as oil prices rebounded from June lows, were other material factors driving ASX performance.

Whilst the Australian market outperformed the US market during July, earnings are likely to be a completely different story. The US reporting season just passed was incredibly strong. Whilst the overall numbers for the US reflect the astonishing performance of the Mag 7, strong fundamentals extend beyond these heavyweights. Excluding the Mag 7, year-on-year growth in sales is 14%, while earnings growth sits at 33%. Apart from Healthcare, every sector in the US is showing real year-on-year earnings growth. In contrast, the broad-based strength in earnings seen across sectors in the US market is not likely to be replicated during reporting season on the ASX, where we expect commodity-linked stocks to lead the earnings charge, while the rest of the market will struggle.

Whilst earnings growth for the ASX200 for FY26 is forecast to be 9%, this is dominated by commodity stocks; ex Resources, there is no growth forecast for this year, following on from 4% growth last year. Perhaps reflecting a triumph of hope over experience, growth for Industrial stocks for the next two years is forecast to be high single digits. Our view is that this is likely to follow the traditional pattern of not being realised and subjected to progressive downwards revision as the year proceeds.

Not that the paucity of growth is slowing demand for ASX200 listed equity, as reflected in high trading multiples. The Australian Industrial market trades on an enterprise value to EBIT ratio of 17x this year's EBIT, with no growth; with 10-year Australian Government bonds yielding 5%, it is obvious that a negligible equity risk premium is being imputed. With the ASX200 at an all-time high, the time to be greedy has passed. Given low growth and high multiples, buying earnings robustness, rather than earnings hope, is the more prudent course for the portfolio.

The strong performance of the banks during the month was somewhat puzzling. Earnings are not improving, and asset growth expectations are declining following the budget and other anti-money laundering changes being introduced in recent months. Given flat to slightly pressured net interest margins, revenues for the sector will follow the path of asset prices in the economy.

The first header of the most recent RBA Statement of Monetary Policy was stark: “What is going on in the economy? Inflation is still too high”. The RBA made its views clear that interest rates won’t be used to buttress any falls in asset prices. The Monetary Policy Board has raised the cash rate three times since the start of the year, but still retains a tightening bias. The conundrum facing sectors and stocks hoping for a better consumer cashflow through interest rate reductions is that any relief looks a long way off; indeed, it is not clear that current settings are far from what should be considered sustainable. In turn, the option the banks had on strong loan growth has been withdrawn - and with it the fuel for the earnings growth of the past two years, tepid as it was. With bad debts still at nascent levels, and the prospects for revenue growth looking ever tougher, in the absence of large-scale productivity programs the option for equity owners of banks at an earnings level is clearly to the downside; and with multiples still at record levels, which were retested through July, the bias for multiples is to the downside as well. With a market capitalisation of $800b, circa 30% of the ASX200, small percentage changes in the market value for the stocks is a large source of potential alpha for portfolios.

Despite these revenue pressures, no material productivity improvement programs have been announced. Bad debts are still tepid, and whilst they cannot be seen as a source of profit improvement from such low levels, equally they are not materially increasing as yet either. In all, changes through the income statement at every line are relatively minor. The multiples continue to be high, especially for the sector outliers – CBA and Macquarie – and whilst globally the banking sector has rallied through the year, offshore the sector has featured very strong earnings growth (as opposed to negligible earnings growth for the sector in Australia) and they also with relatively low multiples.

In the face of this pressure on house prices, strategically there is no doubt the sector faces a fork in the road. A global peer of interest, RBC, in its latest strategic update highlighted six drivers for premium profitability and long-term shareholder value creation; client acquisition and market share gains; increasing revenue productivity; improving cost efficiency; strong eps growth; premium ROE and strong internal capital generation. Whilst this could arguably be seen as more of a wish list than a strategy, as every moving part in the corporate financial model is slated to be bettered, it also stands in stark contrast to the experience of each of the banks in the Australian market currently, as both consumer and commercial banking are seeing returns competed away and disintermediated, either by brokers or the market disruptor. Applying RBC’s six value drivers to the Australian banks sees none of them illustrating and improving trend on a majority of these factors. Any M&A –ANZ, NAB and Westpac have all been mooted as buyers of wealth assets – would likely represent value detriment for existing shareholders. Given the experience of the banks through the Hayne Royal Commission not even a decade ago, it is difficult to believe they want to again revisit a “Bancassurance” model. As in The Odyssey, it is as if this is a Siren song for the banks, representing “All the things you wanted to be, then all the things wish you never wished for”. In short, value options against shareholders exist whether they pursue an organic or inorganic path, unless they pivot towards a productivity focus.

The collapse of Situational Awareness during the month was another stark example of the value, and then the danger, of option value in pricing assets. A geared exposure to a rising asset value brings adulation; a geared exposure to a declining asset value can wreak financial damage, or in the case of Situational Awareness, financial ruin. The value of gearing to an asset holder is hence most magnified when the cashflow yield at market prices for an asset can cover the borrowing cost and is unlikely to decline materially. That sounds like an abstract concept, but that is exactly the profile an investment in Australian commodity stocks that have long life assets and a privileged position on the cost curve can provide an investor when they are purchased at close to book value. In contrast, when applied against assets with high market multiples of current cashflows, gearing increases the potential return, and just as importantly risk, of such an investment exponentially, as Leopold Aschenbrenner and investors, have found to their cost.

A tangible example of this principle applied to an ASX commodity stock in recent years is PLS Group, formerly Pilbara Minerals. As my colleague Mr Conlon has noted, in February 2026, PLS was able to negotiate a contract with Canmax (a leading battery manufacturer) for 150kt of concentrate per annum over the next 2 years (1-year extension option) with a price floor of US$1,000 (SC6). Canmax also provided a US$100m interest-free prepayment. The arrangement has no price cap and, importantly in terms of the option value for a PLS Group shareholder, protects against losses. Another way of looking at this is that the earnings before interest and tax generated by PLS Group in 2023 was $3.2b, or approximately double its asset base and triple its revenue, let alone earnings, of the prior year. To be clear, we do not model another lithium price spike which presaged the showering of PLS Group shareholders with cash in 2023; yet it is equally true that history suggests that in some commodity, at one point through the next decade, such an extreme spike is likely to be seen again. That option always has the potential to exist, even for commodities with a more established supply and demand sources than lithium, and is usually priced cheaply when the outlook for that commodity is most gloomy.

For example, it is possible to now point to such conditions in the coal market a few years ago. A less contentious example, but a far bigger one in terms of ultimate investor return, was that on offer a decade ago when both major miners were lowly geared, and following an aggressive, broad-based decline in commodity prices, were trading under book value. Given they are now trading at four times book value, the gains that have accrued to investors through that time have made the option of purchasing the equity when commodity prices were a very cheap one.

Portfolio Update

Which brings us to where we are positioned in materials today. As my colleague Justin Halliwell has highlighted in the attached slide, it is easy to show that demand for various commodities, including copper, looks strong. What is less obvious is that the option for investors to profit from such a demand outlook is now a cheap one. With a growing acceptance of the strong demand outlook for commodities, share prices for commodity prices have risen in unison; the Materials sector represents more than all of the market’s return in Australia for the past year. Across all commodities, however, spot prices are now above cost curve support, even on a replacement cost basis, and in turn it is difficult to justify valuation support for investment in the sector on a standalone basis at current prices. Amidst a market with several fully priced sectors, and after spending many years since the nadir of 2014 with an overweight stance towards commodity stocks, we have been underweight for some time reflecting this disconnect between a positive near term outlook and the fact that this is more than priced into most commodity stocks currently.

In recent months, we have taken advantage of the opportunity to increase the portfolio exposure to Healthcare following the dramatic sell off in several stocks in that sector, such that it is now, together with Industrials, our largest overweight sectoral position in the portfolio. In several cases within Healthcare, the companies are looking to execute on productivity initiatives, giving us low priced optionality on value being created. In contrast, we continue to be underweight Financials and have decreased our exposure to Materials through recent months as the market has looked to bid up price to book multiples on the back of a positive disposition towards metals prices, reflecting nearer term supply demand factors. The option for dramatic value creation that can occur when metal prices spike, as reflected so graphically in PLS Group in recent years, may exist across many companies exposed to Copper in particular; but it better, because the premium now paid for that option, reflected in the price to book multiple for the equity, is now at close to record highs.

Opinions abound. There are plenty of sage voices expressing caution at asset price levels given the elevated current equity multiples relative to risk-free rates. Nicolai Tangen of Norges spoke to the abnormal past three decades of low taxes, inflation and interest rates, and the danger in extrapolating that abnormality into a base case. Jamie Dimon of JP Morgan also spoke during the past month of the mispricing of risk, seeing “little upside and high risk” in long-dated bonds and major stock market indices. There are also those that are less risk averse, although their numbers took a hit during the month given the demise of Situational Awareness. Within the context of an Australian equity market portfolio, that continues to see us more exposed to Healthcare and Industrial names, and less to those enjoying record levels of profitability at present, notably Banks and some Commodity stocks, especially when they are trading at high multiples. Whilst the market expectation is of accelerating earnings growth in Australia, especially outside of commodity linked names, we suspect that many of these assumptions built upon revenue growth may prove illusory. The hard path to value creation, a productivity focus, is our preferred course.

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