Small- and mid-cap gains highlight 'dangerous market'

Some stocks have soared more than 20 per cent in a day – potentially a warning of overstretched prices and investor euphoria.

Tony Featherstone *Contributor*

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Stocks are said to go up in an escalator and down in a lift. In this bull market, the opposite is true – stocks are soaring on good news and falling less than usual on bad news.

The profit-reporting season has seen prices of mid-capitalisation and small-cap stocks shooting sharply higher this month when results beat market expectation. Some stocks have soared more than 20 per cent in a day – remarkable gains for shareholders and day traders, but potentially a warning of an overstretched market and investor euphoria.

Mind the gap: in theory, mid-cap and small-cap companies have higher growth prospects, so their performance gap with large-caps could be closing as investors pay up for growth. **Simon Letch**

Kitchen appliances maker Breville Group rallied 27 per cent after its half-year result this month, IDP Education leapt 28 per cent and JB Hi-Fi raced 11 per cent higher.

Charter Hall Group, Seven Group, Domino's Pizza Enterprises, Cleanaway Waste Management, Carsales.com and Perpetual also rallied after announcing better than expected profits or upgraded earnings guidance. Challenger, Bapcor and Pinnacle Investment Group were other standouts.

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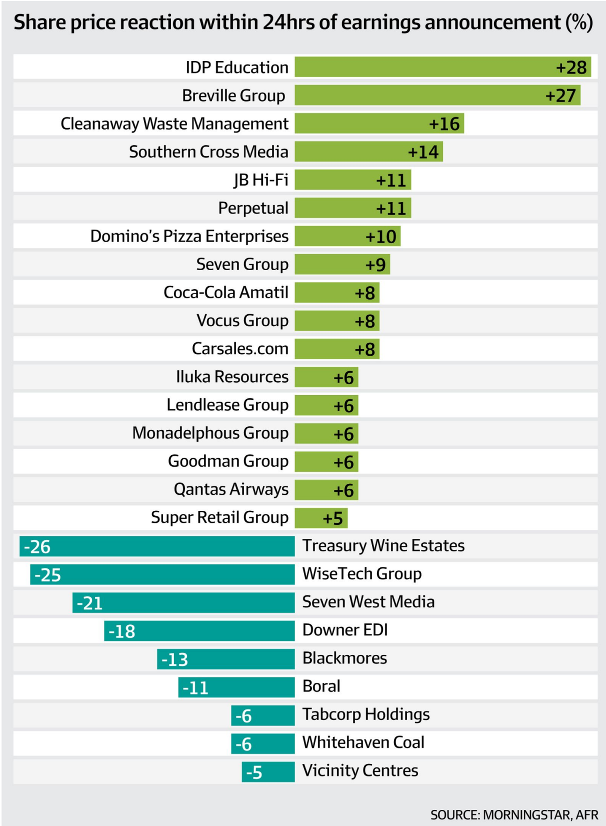
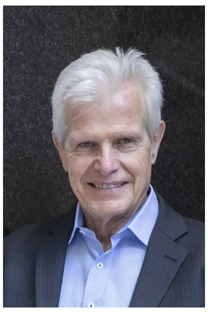


The market's response to poor results has also surprised. WiseTech Group and Treasury Wine Estates shed about 25 per cent after disappointing earnings. But Webjet and Corporate Travel Management, potential losers from the coronavirus, only edged lower despite lowering guidance.

Positive share price responses to earnings results are outstripping negative responses by almost two to one, according to Morningstar Initial Market Reaction (IMR) data. The IMR identifies companies whose share price rises or falls by 5 per cent or more within 24 hours of their result being announced.

Smallco managing director Rob Hopkins is concerned by the size of share price gains in companies that exceed earnings expectations.

"It reeks of too much capital chasing too few companies in a bull market," he says. "Any company with strong growth prospects over the next few years is being bid up to very high valuation multiples, and then ratcheted up again. "



Smallco's Rob Hopkins warns of out-of-proportion share price gains. **Louie Douvis**

Hopkins' Smallco colleague Craig Miller adds: "This reporting season has seen stocks that have moderately beaten consensus analyst forecasts up by 10 to 20 per cent in some instances. That makes little sense. It's dangerous to chase these stocks higher and overpay for them."

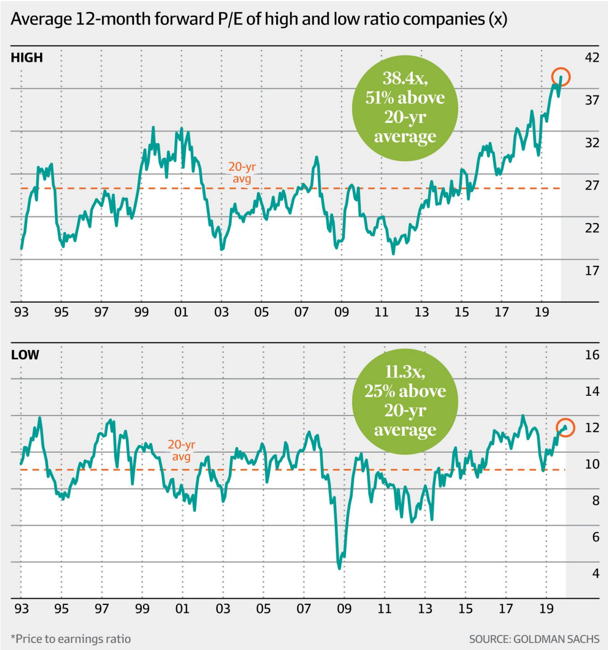
Smallco, a leading small-cap fund manager, is holding more cash in its portfolio than usual. "We are finding it hard to buy enough stocks at current valuations that we would be confident to hold throughout the cycle," says Miller. "We would prefer having more cash available to take advantage of opportunities when valuations inevitably improve."

The trend of stocks gapping higher on good earnings results has been under way for a few years. What has changed is the magnitude of gains upon earnings news. In a low-growth environment, investors are latching on to any sign of growth and paying extra for it.

Investment bank Goldman Sachs distinguishes between firms on high and low price-earnings (P/E) multiples that it researches. High P/E firms are trading on an average of 38 times forward earnings, or 51 per cent above

their 20-year average, wrote Goldman this week. In contrast, low P/E firms traded on an average P/E of 11 times forward earnings.

The average multiple for high P/E firms has skyrocketed since 2012 as interest rates have fallen. Remarkably, high P/E firms now trade at a 71 per cent premium to the Australian sharemarket, on Goldman Sachs numbers, well above their long-term premium average.



Care is needed with historic P/E comparisons: lower interest rates help analysts justify higher valuations for an asset's future cash flows; higher P/E multiples may be a consequence of investors accepting that record low bond yields are here for longer.

Still, that does not explain the pattern of share price rises and falls this profit season, which still has a week or so to run. Smaller companies and poor earnings performers often report late in February, making it hazardous to draw early conclusions. But enough companies have reported to suggest the market is re-rating mid-cap companies with strong earnings growth.

Soaring market darlings

There is no single explanation for the extent of price gains in star stocks. JB Hi-Fi's jump was partly because of short-sellers, who bet on falling prices, having to buy back the stock to cover positions. JB Hi-Fi has had large short positions against it as bears bet on slowing retail sales.

Liquidity is another factor. Solomon Lew's Premier Investments owns 28 per cent of Breville Group, one of this profit season's stars. When buyers rushed to buy Breville after its result, the stock's tighter shareholding and liquidity possibly amplified price gains.

Less coverage of small-cap and mid-cap stocks among broking firms, and closure of some small-cap fund managers, could have contributed to larger price rises this profit season. Stocks are soaring against market expectations that might be wrong because fewer analysts are covering mid-cap and small-cap stocks. However, stocks that soared mostly have had wide analyst coverage.

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Index buying through exchange-traded funds (ETFs) and quantitative trading programs could be another factor for the unusual price action. As mid-cap stocks in the S&P/ASX 200 index rise, ETFs that track this index have to buy more of them, regardless of valuation. Still, it is hard to believe index buying is driving price gains of 20 per cent or more in the likes of Breville and IDP.

Fewer initial public offerings (IPOs), a trend in developed markets in recent years, are another factor. There should be a flood of floats with the sharemarket at record highs, but IPO volumes have been strangely weak. Only five companies, each small, are applying for admission to the Australian Securities Exchange. In the previous share market peak in 2007, 242 floats came to market. The result: less supply of new listed companies and fund managers forced to focus on the same core group of high-quality mid-cap and small-cap companies.

The underperformance of small-cap stocks against large ones is a further consideration. The S&P/ASX Small Ordinaries index, a barometer of stocks ranked 101 to 300 by market capitalisation, has a total return of 16 per cent over one year. The ASX 100 index is up 23 per cent, S&P data shows. In theory, mid-cap and small-cap companies have higher growth prospects, so their performance gap with large-caps could be closing as investors pay up for growth.

Valuations

On a valuation basis, there is little difference between small-cap and large-cap stocks. Small and large industrial stocks are roughly trading on a forward P/E of about 20 times, on Macquarie numbers, even though small-caps should arguably trade at a discount because they are riskier.

Pengana Emerging Companies Fund co-manager, Steve Black, believes low bond yields partly explain higher valuations for companies that beat earnings expectations – and the market's kinder approach to those that do not.

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“More investors are starting to accept that bond yields will remain lower for longer,” he says. “That means analysts can lower the discount rate used to value companies and pay more for future cash flows. A P/E of 40 today is probably a P/E of 30 six months ago if a lower discount rate is used. The market is willing to buy stocks on higher P/Es, but these multiples can mislead.”

International growth is a common theme in star performers, says Black. “Companies such as Breville, IDP and Domino's are delivering good earnings from overseas markets. In an Australian market where growth is hard to come by, investors are favouring companies that can grow faster through their global operations.”

Steve Black says the sharemarket is in a 'glass half full' mindset. **Daniel Munoz**

Ironically, the market used to discount companies that ventured overseas because of corporate Australia's poor record with international expansion. Now investors cannot get enough of mid-cap and small-cap companies with expanding global footprints.

Black says star performers this profit season have, in several cases, justified price gains with exceptional performance. “Breville and IDP, for example, delivered terrific results. Others, like Charter Hall and Seven Group, upgraded their guidance. The market underestimated how well these companies are performing and their price gains reflect that.”

He says the sharemarket is in a glass-half-full mindset. “Our market has had a lot thrown at it in the past 12 months: trade wars, Brexit, bushfires and now the coronavirus, among other things. Yet the market has kept rising. Even companies that have warned about the effects of the coronavirus fell less than expected or rose, in what seems like a 'forgiving' market for now.”

Concern over price action

Black, one of the market's top small-cap stock pickers, is also concerned by the price action this reporting season. "You have to look at it on a case by case basis. Some stocks have genuinely deserved their gains. Others are

being bid up, or not sold off as heavily as they should, given their results, because there are few places to invest elsewhere. That's a worry."

Soaring gains from a small group of mid-cap companies might suggest corporate earnings are in rude health. Not so. Earnings-per-share growth for FY20 will rise by just half a per cent, according to Macquarie Group estimates of stocks it researches. The sharemarket rally is coinciding with limp earnings growth and new risks such as the coronavirus.

The bulls have not had it all their way. Blackmores, Seven West Media, Boral, Downer EDI and Treasury Wine Estates and Domain Australia Holdings fell after disappointing earnings results. Tabcorp Holdings, Whitehaven Coal and Vicinity Centres were other disappointments. Moreover, several stocks that soared after earnings results have given back part of those gains.

Morningstar head of equities research, Peter Warnes, is bearish on market valuations and concerned about price action this reporting season. The Australian sharemarket is 20 per cent overvalued based on Morningstar estimates of fair value, on a market-weighted basis.

"The magnitude of some gains this reporting periods is surprising," says Warnes. "This brings into question the quality of consensus analysts forecasts, continuous disclosure requirements [whether companies are meeting them] and possibly the lack of research coverage."

Warnes believes market complacency is elevated: "The US economic expansion is now 11 years old and the longest in US history. The coronavirus could be more serious than the market is pricing in and potentially trigger inflation and rising bond yields. Stocks on high P/E multiples could look very expensive, very quickly."


More bullish: Angus Geddes

Warnes believes record low interest rates from central banks worldwide are distorting equity valuations more than investors realise. "Eventually that dam will burst. Overpaying for equities because returns are too low in other asset classes is a dangerous strategy," he warns.

Fat Prophets chief executive Angus Geddes is more bullish. He thinks several market headwinds have lessened in the past six months.

"The trade wars have been put on hold, there's been clarity on Brexit and it seems more likely that President Trump will be re-elected," he says.

Geddes expects a V-shaped recovery in China in the second half of 2020 after the coronavirus is contained. "Investment there will come roaring back and base metal prices will rise," he says.

"The ASX 200 could easily get to 7400 or 7500 by year's end. Investors have been too bearish and our market has underperformed US equities for a long time. There's a lot of ground to make up."

Tony Featherstone writes on Personal Finance specialising in Superannuation & SMSFs, Specialist Investments. *Email Tony at tony@featherstone.com.au*

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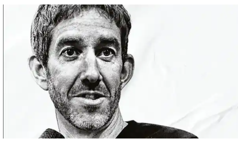

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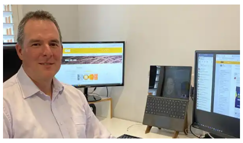

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