

Equity Strategy

Federal Election - Labor To Form Minority Government; Market Implications

Equity Strategy | Australia

Event:

- Following the decision by two of the three Independents to support the incumbent government, the Australian Labor Party (ALP) now has the required number of seats (76/150) to form a minority government. We review the key implications for the equity market of this outcome.

Earnings and Valuation Impact:

- Politics in Australia will certainly not be boring in the period ahead, but the mandate for large changes rests with no political party. It is likely that there will be much discussion and very little new legislation until a clear majority is reformed.
- This issue is further accentuated in the Senate given the large representation of the Greens, adding further complexity to the overall ability of parties to negotiate various policy outcomes.
- It is still not clear what adjustments (compromises) will be required to various policy initiatives in order to successfully navigate both houses of parliament. Key sectors exposed to policy changes include:
 - Resources,
 - Telecommunications and
 - Financial Services.
- We believe there is a risk that the government will not be able to serve its full three-year term.

Investment View:

- Historically, election results in Australia have not provided any significant or investable trends either before or after the election.
- We believe the "perception" of risk around increasing wages and additional taxes/regulatory changes are higher under an ALP government with the Greens controlling the Senate. This will remain a key focus for the RBA given the potential inflation implications.
- We remain positive on the outlook for the domestic economy for the remainder of 2010 and into 2011 based on our strong macro view on improving consumption and continued strong business investment. Our preferred stocks in this environment are: QAN (\$2.53, BUY), MYR (\$3.83, BUY), WES (\$33.33, BUY), TEN (\$1.37, BUY), BKN (\$7.80, BUY) and ORI (\$25.07, BUY).

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Federal Election Result - Finally ...

The final breakdown of the House of Representatives (Lower House) following today's decision by two of the remaining three Independents to support the ALP (Labor Party) in forming a minority government is summarised below (Table 1).

Neither of the major parties has sufficient seats to form a government in its own right (both finishing with 72 seats). The ALP's ability to form a government is dependent on the lone Green party member in the lower house and three of the five Independent candidates' willingness to support the ALP during any no confidence motions and in approving supply (budget).

Table 1

House of Representatives		
	Previous	New
Australian Labor Party	83	72
Greens	0	1
Independents (aligned to ALP)¹	0	3
	83	76
Coalition - Liberal Nationals	55	65
	10	7
Independents²	2	2
	67	74

Source: Australian Electoral Commission

Notes: 1 - Wilkie, Oakshoott & Windsor
2 - Katter & Crook (in new Parliament)

There are a number of key issues to consider about this new "arrangement" going forward including:

- Is a minority ALP government dependent on a coalition with one Greens Independent, one Tasmanian Independent (Wilkie) and two country-based Independents, an arrangement that can provide a stable government?
- What is the prospect that the minority ALP Government will be able to reach a consensus to push through the proposed mining tax (MRRT)? What is the likelihood that all members of the ALP coalition will be able to agree on the detail of a new mining tax plus a Senate which has the Greens holding the balance of power?
- Now that the National Broadband Network (NBN) is virtually certain to be built, how much will it actually cost? What does it mean for Telstra and the other telecommunication players in Australia?
- What else have the two country Independents, one Greens Independent and one Tasmanian Independent been promised, and how much will it cost?
- What is the position in the government that Independent Oakeshott has been offered and what are the implications of him taking the position?
- Will the Independent Katter now change his allegiance and back the ALP, as he indicated in his endorsement of the Coalition earlier in the day?

In an afternoon when financial markets were craving certainty, there remain many unanswered questions. Our concern is that the challenges of maintaining a stable minority government with the disparate aims of the independents will prove too large.

We believe there is a risk that the government will not be able to serve its full three-year term.

Labor Party Regional Commitments

Prime Minister Julia Gillard revealed ~\$10bn in regional commitments that were pledged to the Independent MPs (Table 2). Interestingly, we note:

- The \$763m in new spending initiatives is broadly offset by the savings achieved through deferring the tax discount on interest income;
- \$3.7bn was reprioritisation of infrastructure spending commitments to regional areas;
- \$5.6bn of the \$6bn Regional Infrastructure Fund will be raised from the MRRT, which implies it will be reliant on the Independents supporting the resource tax. We believe this would have been a key difference versus what the Coalition brought to the table over the last 17 days of discussion (since the hung parliament on 21 Aug) given that the Coalition is against the MRRT and would have to fund the commitment from other revenue sources.

Table 2

Labor party regional commitments & policies		\$m
New spending initiatives		
Pacific Highway & Tamworth Hospital redevelopment		763
Reprioritising of commitments to regional areas		
Health and Hospitals Fund exclusively to regional Australia		1,800
Education Investment Fund exclusively to regional Australia		500
Infrastructure investment - prioritisation of national broadband network roll-out to regional areas.		1,400
Committed to during the election		
Regional Infrastructure Fund (\$5.6bn to be raised from MRRT)		6,000
Building Better Regional Cities programs		200
Savings		
Deferment of tax discount on interest income to 2012-13		(700)
Total		9,963

Source: The Australian

Equity Market Implications

As our economics team has previously illustrated (refer *Daily Cable*, "Economics Weekly Comment: Federal Election - Timing and Economic Impacts", 24 March 2010) election results in Australia have historically not provided any significant investable trends either before or soon after the event (Table 3).

Table 3

	Average Change (%)					
	(Over Period Relative to Polling Day*)					
	1 week		2 weeks		1 month	
	prior	post	prior	post	prior	post
AUD/USD	0.5	1.1	1.5	1.5	1.4	1.6
All Ords	0.6	0.0	0.7	0.2	0.8	1.0
10-Yr Bond	-0.6	1.8	-0.6	3.6	-3.2	4.0

*With respect to past 6 elections

Source: GS&PA Research estimates, IRESS

But we indicated that this election presented a greater than usual number of policy differences which will have a discernible impact on the sectors and stocks operating in the targeted areas (refer *Daily Cable*, "Equity Strategy: Federal Election - Market Implications", 19 August 2010).

The main sectors we highlighted as being most exposed to the election result included:

RESOURCES - Coal & Iron Ore

ALP - Mineral Resource Rent Tax (MRRT)

This (and the NBN) represent the most significant differences in policies between the two major parties for investors. The MRRT represents version II of the ill-fated Resource Super Profit Tax (RSPT) which was launched on an unsuspecting market in May 2010 and caused the demise of the former Prime Minister, Kevin Rudd. The MRRT has been agreed to "in principle" by the mining industry following significant changes to the tax rate, allowances, commodities (applies only to coal and iron ore) and retrospectivity (market value). We expect the overall impact to future earnings and valuations (NPV) to be modest (Table 4) although we expect sentiment towards the sector to soften potentially (again) now that the ALP will form a government.

It is certainly worth highlighting that the Green Party prefers the original RSPT with an increase in the tax rate to 50% (from the initial 40%) and a widening of the commodities taxed to include base metals. We would view any move back to the original RSPT (as part of a compromise with the Greens) as a significant negative for the sector and Australia's position as a stable investment market in the global context. The Greens are also calling for a moratorium on all coal seam gas extraction in Queensland and prohibition on the exploration, mining and export of uranium.

The position of the Independents on these particular issues remains unknown at this stage and will be watched closely.

Table 4

	Potential EPS Impact					Potential NPV Impact
	FY13	FY14	FY15	FY16	FY17	
Diversified						
BHP	-3.3%	-1.2%	0.2%	-1.9%	-2.7%	-2.8%
RIO*	-5.0%	-0.4%	0.6%	0.5%	-2.8%	-3.9%
Iron Ore						
FMG	0.0%	-7.6%	-13.3%	-13.0%	-12.2%	-8.5%
AGO	-6.4%	-5.7%	-1.3%	-1.3%	-1.0%	-2.0%
MGX	-10.9%	-8.1%	1.2%	3.2%	5.0%	-0.8%
MMX	0.0%	1.6%	1.4%	1.1%	1.0%	-1.8%
Coal						
CEY	0.0%	1.5%	1.5%	1.5%	1.5%	-0.1%
MCC	-1.3%	1.4%	1.4%	1.4%	1.4%	0.5%
RIV	na	na	na	na	na	na
WHC	-4.4%	-3.8%	-3.5%	-3.6%	-3.6%	-2.7%
* December year end						
Source: GS&PA Research estimates						

TELECOMMUNICATIONS

ALP - NBN Roll-out (total cost estimated at ~\$42bn); TLS has agreed to NBN accessing infrastructure (e.g. pits, ducts), progressive migration of PSTN and cable broadband customers to the NBN and decommissioning the copper network and cable broadband service.

In the *Daily Cable* article, "Telstra Draws A Line In The Sand Following FY10 Results", dated 12 August 2010, our Telco team wrote that under the NBN plan (ALP win), our TLS target price would remain \$3.55 and in a no-NBN world, our TLS valuation would be \$3.79. That is to say, the Coalition's plan would not change our TLS valuation materially; therefore, we are reasonably neutral on the overall impact an ALP or Coalition win would have on the sector.

Given the emphasis that the Independents supporting the ALP have placed on the roll-out of the NBN, we suspect this will remain a key issue in their ongoing support.

FINANCIAL SERVICES

SUPERANNUATION

ALP - proposing to raise the SG rate from 9% to 12% over the next 10 years and other initiatives to boost contributions.

ALP has also backed a couple of the main recommendations from the Cooper Review:

- MySuper (a simple, low cost product for "default" members) by 2013;
- SuperStream (a series of initiatives to streamline administration and reduce costs) starting with the introduction of TFNs as a unique account identifier.

Net Impact - ALP would be better from a "FUM growth" perspective (long-term growth), although the wealth managers are still exposed to a potential "fee squeeze" (short term).

ANNUITIES

- Both parties rejected calls for government-provided annuities and/or compulsion.
- It was unclear which party might be more likely to introduce tax breaks for annuities (over lump sums).

FINANCIAL PLANNING

- ALP proposes to ban all commission payments on wealth management products and introduce formal "fiduciary" obligations.

LIFE INSURANCE

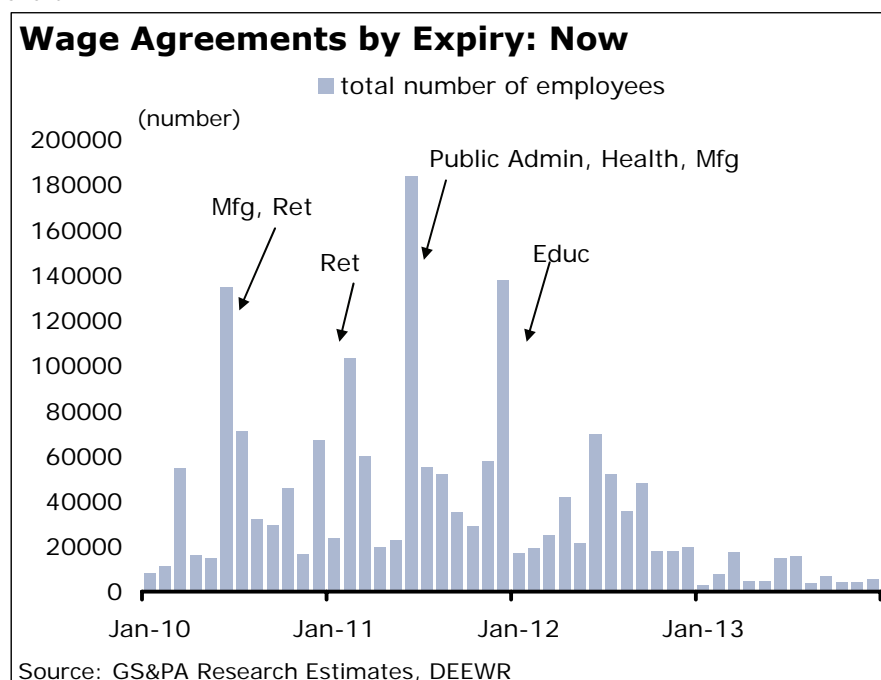
- ALP is considering extending its ban on commissions from wealth management to life insurance. This would be a negative for sales growth.

INDUSTRIAL RELATIONS/LABOUR MARKET

Both parties committed to no further changes to the existing workplace relation legislation enacted by the current ALP government for at least the next term of government.

We suspect investors will adopt a more cautious view on this key issue under an ALP government. The key risk here is the potential for wage increases to accelerate in 2011 and 2012, particularly with a large number of wage agreements due to expire across a number of major employee groups over the next two years (Chart 1). This is also occurring against a backdrop of minimal spare capacity in the labour market as Australia is already close to full employment (as measured by NAIRU).

Chart 1



While it is difficult to conclude definitively that we are on the verge of a wages break-out, we believe this issue and the subsequent management of it by the government (and the RBA) will remain a key focus for investors as we head into FY11 and FY12.

From a top-down perspective, we have run a screen looking at labour intensity and pricing power to try to establish which companies: 1) are large Australian employers 2) have a high proportion of their cost base comprised of salaries and wages and 3) have the ability to absorb and pass on costs through pricing power or offset through cost-out without a significant impact on demand or competitive position. Based on this we believe:

- Clear winners in a higher labour cost environment are companies with a relatively low labour base and/or strong pricing power: TCL, AIX, ITO, MAP, ORG, AGK, the banks.
- Labour-intensive businesses with pricing power should be able to absorb and pass on, or offset through cost-out, higher wage costs: WOW, WES, RHC, CCL, AIO, TOL, DJS, MYR, QAN.
- Businesses vulnerable to rising labour costs (owing to a higher labour base and tending to lack pricing power) are: TLS, VBA, TAH, OST, BSL, PBG, SPT, TSE, LEI, SHL, PRY, FXJ.

ERP/OFFSHORE INVESTORS

The final key issue for investors/equity markets remains the perception of risk, particularly with respect to the implied equity risk premium (ERP) that investors, particularly offshore, will assign to the equity market.

Anecdotally, we believe offshore investors are currently underweight Australia, reflecting a series of selling events: the GFC and the expectation that Australia would head into a significant recession; the expectation this would still occur but with a delay as markets rallied; the view that Australia was now expensive relative to other markets; and finally, the surprise introduction of the Resources Super Profit Tax by the current ALP government. We believe offshore investors remain highly sceptical of the long-term intentions of the ALP and the potential for additional taxes/regulation to be introduced during the next term (the banking sector being a key area of concern). This risk will only have increased given the alignment of the Greens with the ALP in this "new government" and questions as to what will be the "quid pro quo".

We therefore expect offshore investors to remain cautious about up-weighting Australia given that the ALP will be returned.

OTHER ISSUES OF INTEREST

Other areas of policy difference which we believe are worth highlighting are:

Company tax

- Labor: 1% decrease to 29% from 2013/14 (one year earlier for small business, i.e 2012/13).

Health

- Labor: Under its National Health & Hospitals Network program, plans to take over 60% of state-managed hospital funding. \$276m over four years has been targeted for mental health and suicide prevention. Labor remains committed to Medibank Private remaining government-owned but plans to declare a \$300m special dividend to assist funding its election commitments.

Climate

- Labor: 5% carbon emissions cut by 2020. Carbon emissions trade scheme delayed until the end of the Kyoto period in 2012 and dependent on what other countries do. An assembly of 150 people to help build consensus for a price on carbon and \$2,000 rebate towards new vehicles for trading in pre-1995 cars for scrapping.
- Greens: a two-year carbon tax set at \$23/t on the biggest polluters, with \$5bn returned to households and long-term 100% renewable energy target and \$4.5bn in green loans for big renewable energy projects.

Parental leave

- Labor: Fund 18 weeks on minimum wage from January 2011.

Summary

Politics in Australia will certainly not be boring in the period ahead, but the mandate for large changes rests with no political party. We believe it is likely that there will be much discussion and very little new legislation until a clear majority is reformed.

Irrespective of the election result, we remain positive on the outlook for the domestic economy for the remainder of 2010 and into 2011 based on our strong macro view on improving consumption and continued strong business investment.

Our preferred stocks in this environment are:

- **QAN (\$2.53, BUY),**
- **MYR (\$3.83, BUY),**
- **WES (\$33.33, BUY),**
- **TEN (\$1.37, BUY),**
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