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Wealth

Speed bumps ahead for Kogan, a2 Milk

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Once again, as some investors leave the party, even as the band keeps playing, many are only beginning to wonder whether stocks can fall. Indeed, in recent days a record $US34 billion ($44bn) flowed into equity index exchange traded funds.

And when it comes to equities, be certain of this: there are market darlings today whose share prices will decline 50, 60, 70 and even 90 per cent in the next 12-24 months. The argument for a reversal of financial conditions is not only becoming more plausible. It's actually now visible. And be sure to zip up your wallet if someone suggests that because Australia's stockmarket didn't rise as much as the US, it won't fall as far. That kind of nonsense has no place in a world where correlations increase as markets dislocate — the baby always gets thrown out with the bathwater.

Speed bumps are emerging for highly prized companies, questioning earnings multiples that can only be justified by high double-digit profit growth rates.

When e-retailer Kogan (KGN) announced a few days ago it will offer pet insurance, its shares shot up 14 per cent. The market also reacted positively to Kogan's announcement it will start selling fixed-line NBN broadband connections, partnering with Vodafone. The fact is it is entering an industry where larger, more established players such as Telstra (share price down 31 per cent from one-year highs), Vocus (down 44 per cent) and TPG (down 20 per cent) are suffering from intense and arguably irrational competition and declining margins.

And on Amazon's intention to launch in Australia, in direct competition with smaller players, Kogan told News.com.au: "We're excited by Amazon's launch, anything that can be done in Australia to bring more significance to our online retail industry to make more people aware of it, the better." Shortly after the comments, Kogan's founder announced he had sold $50 million of shares in the company he founded.

Similar, and arguably misplaced, optimism is evident in the market for infant formula. Listed distributor a2 Milk (A2M) has seen its shares soar more than 700 per cent in little more than two years amid optimism about sales success in China. On March 28, 2018 Nestle, the world's biggest food and beverage company, announced the launch in China of an infant formula that uses the A2 beta-casein protein made popular by the a2 Milk Company. A2 Milk's response to the entry of a super competitor is almost identical to Kogan's: "(We) consider that new entrants should assist in building credibility and awareness for the A1 protein-free proposition, and hence build the overall category more quickly." How can it be that more competition, especially from global giants, is universally good for everyone? Wake up! Ask Myer what happens when Amazon, Zara and Uniqlo turn up to compete. Equity investors are still flirting with market highs and pumping record amounts of money into ETFs undaunted by the prospect of Amazon hurting Kogan's plans or Nestle disrupting a2 Milk's. But globally, corporate bond investors are evacuating the scene. The Bank of America Merill Lynch BBB bond spread has widened to its highest level in six months and yields are near the highest levels seen since 2012.

The recent equity bull market can be characterised by a concentration of investment flows into a narrow band of concept stocks. The prices of these stocks imply uninterrupted earnings growth of 30-40 per cent a year for the next decade. Such growth paths transpire much less frequently than the preponderance of companies whose share prices reflect such hopes. It's time for investors to be very, very careful.

With the cost of private debt now rising (3 month US Dollar LIBOR interest rates have risen almost fourfold from 0.61 per cent in January 2016 to 2.29 per cent now), even in the absence of central bank intervention, investors are being surprised to discover that emerging doubt about the prospects for earnings growth can manifest itself in lower price-to-earnings multiples.

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