

31 August 2022

Market Review

Australian equities were slightly up in August, despite dropping off in the last few days of trading. The Australian dollar also declined against the US dollar, to below 70 cents once more. Meanwhile, commodity prices arrested their recent fall, rising in both SDR and local-currency terms.

Australian equities had a solid month before, despite they lost ground late on after hawkish comments from Jerome Powell, the Federal Reserve (Fed)'s chair, which led to declines in global equity markets, including Australia. While all sectors ended the month down, the technology sector once again suffered the most, although the declines were broad-based in general. Corporate earnings releases have, so far, been solid across the board, although many companies are indicating a deteriorating outlook for the current financial year.

In economic news, the Reserve Bank of Australia raised interest rates again, taking them to 1.85%. It guided that further hikes were likely, depending on future economic data and the inflation outlook. Elsewhere, Australia's Purchasing Manager's Index fell into contractionary territory for the first time since January. National Australia Bank's latest business survey, somewhat surprisingly, showed an uptick in business confidence. However, according to Westpac's survey, consumer sentiment continued to decline to levels only seen during the outbreak of Covid-19 and the Global Financial Crisis.

Portfolio Review

The Fund returned +1.21% (gross of fees) and +1.14% (net of fees) in August. This was in line with its performance target, which returned +1.18%.

Contributing to performance was our stock selection in the materials sector, with both Oz Minerals and Pilbara Minerals performing strongly. Oz Minerals rose strongly after it received a non-binding indicative proposal by BHP to acquire the company at \$25.00 a share. The board swiftly rejected the offer, citing that it

undervalued the business. Our view is that the proximity of the assets means that BHP is in a unique position to extract valuable synergies. Therefore, we believe the initial offer may not necessarily be the last. Meanwhile, the tight lithium market continued to support elevated pricing for Pilbara Minerals amid news of Chinese power outages further affecting domestic production. We continue to view the business as a high-quality operator within the space, although am equally mindful that current elevated prices would continue to induce new supply to come online over the medium term. Elsewhere, our holding in Medibank boosted returns, with the company reporting good results thanks to solid policyholder growth and subdued claims inflation. Our view is that health insurers like Medibank will continue to benefit from the benign claims environment as the healthcare industry continues to grapple with labour shortages.

On the other hand, our lack of exposure to BHP hurt returns as the diversified mining conglomerate reported in-line results, supported by very strong free cash flows. That said, its share price fell towards the end of the month as the stock went ex-dividend. In addition, our overweight to the information technology sector weighed on returns, as the technology sector as a whole gave back some of the gains witnessed in the prior month's rally after Jerome's Powell speech at Jackson Hole, where he reiterated the Fed's commitment to containing inflation. Our overweight to Megaport was consequently a notable detractor. Finally, ASX was a laggard as the company provided yet another disappointing update regarding its CHES replacement project, which has been pushed out to late 2024 (a soft target), while an independent review will be conducted. We suspect this could lead to further cost blowouts, though note that no revenue upside is being assumed by the market on this project; however, the core business remains well run.

In terms of fund activity, we increased our exposure to Resmed, Cochlear and CSL over the month. For Resmed, we expect the microchip shortage to ease, while Philips'

Investment strategy³

The Fund utilises abrdn's Sustainable and Responsible Investment process to invest primarily in a concentrated portfolio of around 20-35 companies that are listed or proceeding to listing on the Australian Securities Exchange (ASX) and have the potential for capital growth and increased earning potential.

Investment objective

To outperform the benchmark, the S&P/ASX 200 Accumulation Index, after fees, over rolling three year periods.

ability to bring volume back to the market is likely to be slow, enabling Resmed to further gain market share. We increased our position in Cochlear as we have confidence in its earnings trajectory and potential for new product launches. We also have confidence in CSL's earnings trajectory for its plasma core business as supply returns to the market.

Conversely, we reduced our position in Mirvac. Sentiment remains weak across its residential and office properties, as well as new developments (given elevated construction costs), and, in our view, is unlikely to turn positive for some time. However, we continue to like the company, as well as management's execution to date.

Outlook

Inflationary pressures, which in many cases are just peaking, combined with aggressive and ongoing increases in global interest rates, are providing the right ingredients for an economic slowdown.

We remain cautious for the remainder of 2022. Early evidence of consumer belt tightening is showing due to the rising cost of living and higher mortgage servicing costs, which should continue to translate into a slowdown in demand. If cost pressures continue to run rampant, the risk of stagflation increases and an economic recession is likely to follow.

The latest reporting season continued to reflect the strength in corporate earnings, as well as balance sheets, over the first half of this calendar year. However, our view continues to be that the former has the potential to unravel much quicker than the market expects, while balance sheet strength should already be of elevated focus for any management team given rapidly rising debt costs. While we have seen a slight downward revision in market expectations for the forward period, we continue to take the view that only earnings multiples have normalised (mainly driven by the rising cost of capital). In contrast, earnings estimates generally continue to remain elevated and have yet to fully capture the increasing risks of slowing economic growth.

Given this volatile backdrop, our portfolio positioning remains biased to businesses that offer strong pricing power and those that exhibit defensive business moats. We continue to be cautious on rate-sensitive sectors and businesses that are just beginning their journey towards profitability.

We remain committed to our 'bottom-up' investment style, with a focus on quality companies. We favour businesses with clear growth prospects that are leveraged to long-term structural shifts. Our holdings' defensiveness, in terms of their robust balance sheets and prospects for generating healthy through-the-cycle earnings and dividend growth, is an added advantage. Many of our companies are also leaders on governance and sustainability, positioning them well to adapt to future challenges and opportunities. This will ensure that the portfolio remains resilient despite the current uncertain environment.

Fund performance is available on the relevant factsheet.

The opinions expressed are those of abrdn as of the date of publication and are subject to change at any time due to changes in market or economic conditions.

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