

30 September 2022

Market Review

Australian equities fell in September, in line with the majority of global equities. The Australian dollar continued its decline against the US dollar, falling to its lowest level in over two years. Meanwhile, commodity prices fell slightly in SDR terms.

Australian equities appeared to be recovering the ground lost at the end of August, after the conclusion of a reasonably solid reporting season. However, a higher-than-expected US inflation print for August caused markets to fall globally, with the US Federal Reserve indicating it would continue to aggressively hike rates, despite the growing risk of a recession. While all sectors in Australia fell, small-cap stocks fared worst, in particular resources and real estate investment trusts (REITs). At the same time, consumer staples did not exhibit the defensive characteristics normally expected at this period in an economic cycle.

In economic news, the Reserve Bank of Australia (RBA) raised interest rates again, taking them to 2.35%, in line with expectations. It guided that further hikes were likely but dropped its wording around requiring higher rates to normalise monetary policy. This indicates we may be closer to the terminal rate, and future rate hikes might be slower. Meanwhile, Australian second-quarter GDP was in line with expectations, growing 3.6% year on year and 0.9% quarter on quarter. The Australian economy added 33,500 jobs in August; while the participation rate increased by 0.2% to 66.6%, the unemployment rate edged up by 0.1% to 3.5%. In September, Westpac's Consumer Sentiment survey finally reversed its decline from December 2021 but remains low historically, at 84.4.

Portfolio Review

The Fund returned -5.35% (gross of fees) in September. This was ahead of its performance target, which returned -6.17%.

Contributing to performance again was our stock selection in the materials sector, with both Oz Minerals and Pilbara Minerals continuing to perform strongly. Pilbara

Minerals continues to benefit from an elevated pricing environment which has been exacerbated by structural supply shortages, with realised pricing at its September auction 10% higher than the early August equivalent. Strong electric vehicle growth in the US and China, and sales rebounding in the European market, have also contributed to a buoyant lithium pricing environment. Oz Minerals continued its strong performance on reports that BHP Group was considering raising its standing offer, with BHP looking to boost its exposure to metals central to the green energy transition. The company also approved the development of its West Musgrave project. Elsewhere, Resmed outperformed as its key competitor (Philips) suffered yet another minor setback, this time concerning its sleep apnea mask products.

On the other hand, Xero was caught up in a sector-wide selloff, with growth stocks out of favour for investors as global rates expectations rose after a strong August inflation print in the US. No stock-specific issues were identified. Similarly, there was no fundamental news flow to explain Goodman Group's underperformance. However, the stock heavily sold off, alongside the rest of the REITs sector, as US policymakers forecasted significantly more aggressive use of interest rates in an attempt to bring inflation under control. Finally, Pinnacle Investment Management weighed on performance, given its key underlying earnings driver (funds under management) is heavily linked to market movements.

Activity

In terms of Fund activity, we initiated a position in Infratil, given it had a reasonable valuation with some potential upside catalysts as well as an improving ESG house score. Infratil is an externally managed global infrastructure investor with a competitive advantage in the form of access to deal flow. Its portfolio of digital infrastructure, renewables and healthcare assets is well suited to an ESG strategy. We also initiated a small position in Pro Medicus, taking advantage

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.

of a recent sell-off, with the stock falling below \$50 per share. It is a high-quality imaging software provider operating on a capital-light, recurring revenue model, backed by continuous contract wins with further medium-term market expansion opportunities. Elsewhere, we increased our position in Elders after the stock sold off due to a fall in the Eastern Young Cattle price Indicator as a result of foot and mouth disease, an issue we expect to be transitory.

Conversely, we slowly reduced our position in Pilbara to take profits. After a period of very strong share price growth (with an increase of over 100% in the quarter to end-September), we saw the valuation as beginning to look quite stretched and wanted to manage risk, though we still remain materially invested.

ESG Engagement

It was a busy month in terms of ESG engagement. We met Spark NZ to discuss its emissions reduction and energy efficiency programme. We discussed its goal to reduce scope 1 and 2 emissions by 56% by 2030, from a fiscal year 2020 baseline, including exploring how they can decouple growth from emissions by linking energy procurement to new sources of renewable energy. We also met with Pro Medicus to follow up on some of our prior recommendations. These have progressed well, with board diversity and committee independence improved, along with the introduction of data security disclosures. We note that MSCI has also upgraded PME from 'B' to 'BBB' over the last 24 months after our continued engagement with the company.

Outlook

Inflationary pressures that in many cases are just peaking, combined with aggressive and ongoing increase in global interest rates is providing the right ingredients for market volatility and rising recessionary concerns.

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

This has various implications on both the outlook for corporate earnings and stock valuations. Despite equity markets already experiencing a drawdown year-to-date, our observation is that only earnings multiples have normalised, mainly driven by the rising costs of capital, although earnings estimates

remain fairly robust 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-cycle earnings and dividend growth, is an added advantage. Many 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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