

31 October 2022

Market Review

Australian equities rose in October, in line with the majority of global equities. The Australian dollar continued its decline against the US dollar, hitting a new two-year low before rebounding slightly. Similarly, commodity prices continued to drop back from their recent highs earlier in the year.

Australian equities had a solid month as investor confidence improved globally on the possibility the US Federal Reserve could slow down the pace of hikes after softer economic data in the US. Lithium companies continued to show strong performance, although some of the larger mining firms and industrial cyclicals underperformed.

In economic news, the Reserve Bank of Australia (RBA) raised interest rates again, to 2.60%, which was 25 basis points below expectations. However, third-quarter inflation came in above expectations, at 1.8% quarter on quarter and 7.3% year on year. This caused the RBA to raise rates again on 1 November to 2.85%

- the fastest tightening cycle since 1994. Meanwhile, Australian employment data for September came in below expectations, with just 900 jobs added during the month versus the expected 25,000. The participation and unemployment rates held firm at 66.6% and 3.5%, respectively. Elsewhere, while NAB's Quarterly Business Survey continued to show solid conditions over the third quarter, Westpac's Consumer Sentiment Index for October further declined to 83.7 and remained near historic lows.

Portfolio Review

The Fund returned 4.52% (gross of fees) and 4.45% (net of fees) in October. This was behind its performance target, which returned 6.04%.

Detracting from performance was our overweight to Medibank. The company is battling a very public and ongoing data breach that resulted in the theft of customer information by cybercriminals. While investigations will take time to finalise, it remains difficult to ascertain the longer-term impact on the brand and customer

churn, while there will also be remediation, legal and other costs. Investors tend to assume the worse, and the share price has been accordingly affected. After a period of strong outperformance, OZ Minerals detracted in October. The company remains in the crosshairs of mining behemoth BHP, which had earlier proposed to acquire the business. While BHP's initial offer was swiftly knocked back by the OZ Minerals board on valuation grounds, public comments made by BHP suggest that it will be disciplined around increasing its offer price, which resulted in a softening share price for OZ Minerals during the month. OZ Mineral's high-quality copper assets remain very strategic to BHP and are increasingly crucial for the upcoming clean energy transition. Elsewhere, Megaport weighed on returns after a disappointing quarterly update. The new channel sales strategy is yet to produce results, and the company surprised investors with higher costs and capital expenditure, which have cast some doubt on Megaport's ability to self-fund itself to break even.

On the other hand, our overweight to IDP Education contributed to returns. While there was not any company-specific news, investors looked favourably on international student visa statistics that showed a marked improvement in the volumes of visas being granted to students from IDP's key source countries, such as India. It was also pleasing to note that higher education visas granted in the quarter to September exceeded the same quarter pre-COVID-19 in 2019. National Australia Bank also added to returns, with investors responding favourably to stronger near-term net interest margins driven by positive deposit spreads, which will positively affect bank earnings in the short term. In the medium term, increasing competition, a weakening macroeconomic outlook and rising cost inflation are likely to offset some of these tailwinds. Finally, Shopping Centres Australasia staged a strong rebound in October. The real estate investment trust's key tenants are non-discretionary retailers, including the major supermarket chains, which are likely to provide strong rental income despite a weakening economic

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.

outlook. Furthermore, RBA's dovish tilt also provided further optimism that we are approaching terminal interest rates.

Activity

In terms of Fund activity, we gently topped up our position in supermarket operator Woolworths. We expect food inflation to remain an ongoing theme, while the low price elasticity of food-related spending in a potential economic downturn should be beneficial for the company's performance.

Conversely, we took some profits in copper miner OZ Minerals, given the ongoing interest from suitor BHP is likely to take time to reach fruition and the global economic backdrop appears to be deteriorating, which may weigh on copper prices in the near term.

ESG Engagement

We engaged Auckland International Airport (AIA) on climate change, including its strategies to mitigate and adapt in this area. On the topic of adaptation, we found it positive that AIA is doing representative concentration pathway scenario modelling and upgrading its infrastructure to combat the physical impact of climate change, with a focus on severe weather. As to mitigation, AIA is already optimising taxi ways and arrival paths and starting to deploy ground power units. It is also starting to consult on whether some environmental or noise metrics should be incorporated into landing charges, but AIA is keen to avoid unintended consequences. This was a fruitful engagement exercise, and we will continue to monitor AIA's progress over the next 12 months.

Outlook

Inflationary pressures remain the key concern for investors, with most recent data points showing limited evidence of any easing. While inflation may well be nearing its peak, aggressive and ongoing increases in global interest rates are likely to persist in the short term, coupled with increasing risks of an economic slowdown. This will likely see higher market volatility remaining a feature for some time.

We remain cautious for the remainder of 2022. The recent trading updates from many Australian corporates revealed that, while consumer spending is still brisk, early signs of belt-tightening can be seen, with some companies reporting slowing sales momentum. Meanwhile, cost pressures and higher-than-normal inventory positions also increase the risk of a discount cycle should consumer demand slow markedly. Consequently, we expect that the retail

trading period in the run-up to Christmas will be an important indicator of consumer sentiment. There remain elevated earnings risks for consumer-facing businesses over this period, and the Christmas trading outcome will also set the tone for operating conditions as we enter 2023.

Given this volatile backdrop, our portfolio positioning remains biased toward 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 toward 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 (i.e., 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 in 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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