

31 December 2022

Market Review

Australian equities fell in December, in line with most other markets worldwide. The Australian dollar was flat against the US dollar, while commodity prices were also little changed over the month.

Australian equities fell in the final month of the year but outperformed most global equities, with positive returns over the calendar year. Recessionary fears dented investor confidence after the US Federal Reserve (Fed) indicated further interest rate hikes would be likely in 2023, surprising investors after a lower-than-expected US inflation figure for November. The purchasing managers' index reading for Australia continued to fall more than expected in November, with the measure now firmly in contractionary territory.

In economic news, the Reserve Bank of Australia (RBA) raised interest rates again during the month, to 3.10%, with further rate rises expected in 2023. Employment data supports this view, with a higher-than-expected 64,000 jobs created in December, along with an improved participation rate of 66.8%. However, GDP data was weaker than expected for the quarter to end-September 2022, with annual growth of 5.9% versus expectations of 6.2%.

Portfolio Review

The Fund returned -2.31% (gross of fees) and -2.37% (net of fees) in December. This was ahead of its performance target, which returned -3.21%.

Contributing to performance was our overweight in Spark New Zealand. The company announced that its TowerCo business Connexa will acquire 2degrees' tower assets, as well as close Spark Sport. Both announcements, while small in isolation, are incrementally positive, as the former suggests co-location benefits and thus valuation upside to Connexa, while the latter results in cost savings to the business. OZ Minerals continued its strong performance, thanks to its pending takeover by BHP. This supported the OZ Minerals' share price, despite the broader market falling due to growing concerns of

a recession in the year ahead. Auckland International Airport also outperformed the broader market, buoyed by news regarding the relaxation of China's 'zero-Covid' policy, which should further boost a recovery in international passenger volumes.

On the other hand, our lack of exposure to benchmark heavyweight BHP detracted from performance. BHP's outperformance was driven by the China reopening theme, with Chinese policymakers seeking to relax Covid-19 restrictions and support the property sector, which flowed through to higher iron ore prices. Having performed well over recent months, Pilbara Minerals underperformed, with recent market commentary and spot pricing suggesting that the lithium price may have passed its peak, which negatively affected the company's share price. Elsewhere, Charter Hall Group weighed on returns, despite no fundamental news. Its share price fell in line with the rest of the real estate investment trust sector as US 10-year bond yields crept back up on concerns that rates are likely to stay elevated for longer in the year ahead.

Activity

In terms of Fund activity, we chose to take profits and reduce our active positions in both OZ Minerals and Auckland International Airport. OZ Minerals' share price was trading close to BHP's latest revised offer of A\$28.25, and we believe the board will be recommending the proposal to OZ Minerals' shareholders and that the deal will successfully transact. Regarding Auckland International Airport, while the travel recovery has been a strong tailwind, Price Setting Event 4 is ongoing, and some uplifts, such as that for duty-free shopping, will likely be less meaningful. Finally, Auckland Council's proposal to sell down its 18% interest could also act as an interim overhang for the stock.

Outlook

As we head into the new year, noting that economic conditions are typically slow-changing, our macroeconomic position, in summary, remains one of caution.

Over in the US, while the rate hiking period

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.

is close to its peak, we remain wary of the Fed's conviction in bringing inflation well under control, meaning elevated rates and restrictive monetary conditions could well persist for an extended period of time. This is unlikely to bode well for equity markets, particularly when we compare this to the bond markets, where investors continue to anticipate rate cuts towards the second half of this year. From an economic perspective, we still believe a material economic slowdown will occur, as the typical US consumer has been significantly weakened over the course of 2022 thanks to inflation. This will likely flow quickly through to corporate earnings and a further pullback in capital investments.

As for Australia, while the RBA is also looking to re-establish its credibility, we take comfort that our local policy transfer mechanism is faster and that our policymakers appear to be more cognisant of an overreliance on what are effectively lagged economic indicators. With China also looking to exit its 'zero-Covid' policy, we are generally more optimistic on the domestic market and those companies whose operations are confined locally, with the view that Australia has a higher probability of achieving a soft landing.

With the last reporting season continuing to demonstrate strength in corporate earnings, with balance sheets solid, we think the upcoming reporting season will be very telling. Corporate earnings have the potential to unravel much quicker than investors expect, while balance-sheet strength will be more heavily tested given rapidly rising debt costs. While we have seen downward revisions in investor expectations for the forward period, we continue to believe that only earnings multiples have normalised (mainly driven by the rising cost of capital). In contrast, earnings estimates have yet to fully capture the impact of subdued 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 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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