

30 June 2022

## Market Review

Australian equities fell in June, in line with the sell-off in markets worldwide. The Australian dollar weakened against the US dollar over the month, hitting its lowest level since 2020. Meanwhile, commodity prices dipped for the second month in a row.

Australian equities continued to fall in June, weighed down by concerns of a recession as interest rates continue to rise globally as central banks try to counter persistently high inflation. The Reserve Bank of Australia (RBA) was no different, surprising the market with a larger-than-expected 50-basis-point rise. The RBA also guided that further rate rises were likely in the coming months. Losses were fairly broad-based across sectors, but were led by growth-oriented ones, as has been the trend for most of the year.

In economic news, NAB's latest business survey still showed high (if slowing) confidence. On the other hand, Westpac's consumer sentiment survey has now dropped to levels normally associated with weak economic growth or a recession, reflecting concerns over the rising cost of living. Other data points were encouraging, with job vacancies rising to a record 480,000 in May, while retail sales for the same month were also solid, growing 0.9% from April. However, none of this economic data reflected the recent rise in interest rates, so June's releases will be keenly anticipated by the market.

## Portfolio Review

The Fund returned -7.94% (gross of fees) and -8.00% (net of fees) in June. This was ahead of its performance target, which returned -8.77%.

Contributing to performance was our overweight to the consumer staples sector, with both Coles Group and Woolworths Group performing strongly. Both companies were beneficiaries of the structural move away from the consumer discretionary sector to the more defensive consumer staples sector. Additionally, food inflation should be a boon to both companies, helping to reinvigorate growth into what

is otherwise a highly mature sector. Also benefitting from the move to more defensive assets was renewable electricity generator and retailer Mercury New Zealand. Its strong earnings visibility was viewed favourably by the market, adding to performance.

On the other hand, our stock selection within the materials sector dragged on performance, as both Oz Minerals and Pilbara Minerals underperformed. Oz Minerals' share price dropped following the steep fall in the price of copper off the back of concerns that aggressive rises in interest rates will lead to an economic slowdown. These recessionary concerns also affected Pilbara Minerals, with the market expecting slower sales of electric vehicles to cause a softening in demand for lithium, despite spot prices currently remaining elevated. Elsewhere, our exposure to Megaport weighed on returns as it becomes more evident that its change in sales strategy is likely to drag on its growth outlook in the short term. Furthermore, with its profitability expectations delayed, it has been caught up in the global sell-off in growth-focused companies.

In terms of activity, we initiated positions in Elders and IPH. Elders is a well-run agricultural services business, with strong capital discipline and multiple internal growth options. Elders is expected to benefit from strong ongoing seasonal conditions and offers the potential for bolt-on acquisitions. IPH is a patent services firm with an extensive global clientele and dominant market positions in Australia and Singapore. We expect existing patent case files to provide IPH with a highly visible and recurring stream of revenues, given that the typical patent life cycle can exceed 20 years. In addition, IPH is well-positioned to continue to grow its network, particularly in the less mature regions of South-East Asia. On the other hand, given weakening consumer sentiment, we reduced our position in Wesfarmers to reflect rising earnings risks for key operating businesses, such as Bunnings and Officeworks.

## Outlook

## Investment strategy<sup>3</sup>

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.

The combination of inflationary pressures - that are, in many cases, just peaking - and the aggressive and ongoing increases in global interest rates are providing the right ingredients for a potential economic slowdown.

Given this backdrop, we are taking a cautious view for the remainder of 2022. Increasing evidence of reduced consumer spending, as the rising cost of living and higher mortgage servicing costs take their toll, is likely to translate into a demand slowdown. Moreover, 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 steep drawdown in the first half of 2022, our observation is that only earnings multiples have normalised, mainly driven by the rising cost of capital. However, earnings estimates remain fairly robust and have yet to fully capture the rising risks of slowing economic growth. As a result, the upcoming earnings season is likely to reveal signs of initial softness, and we expect market expectations for earnings growth to be progressively revised downwards.

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 interest rate-sensitive sectors and companies 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 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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