alphinity INVESTMENT MANAGEMENT

Monthly Report – November 2021
Alphinity Concentrated Australian Share Fund

Black Friday

Market comment

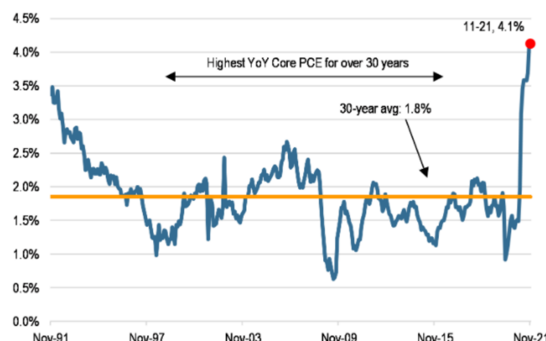
The Black Friday 'sales event' has become quite a thing in Australia in recent years, threatening to eclipse Boxing Day as the biggest sales period for retailers. It is a US phenomenon where for years the day after Thanksgiving has traditionally been when Americans start shopping for Christmas. It is supposedly the day on which retailers finally make it into the black – i.e. become profitable – after making losses for the first 47 weeks of the year, relying on Christmas sales to be viable. Here, it is just a convenient way for people who are organised enough to save a bit of money on Christmas presents.

The markets had a Black Friday Sale too but it wasn't 30-50% off as in the shops though. It started in Australia that day when the market (ASX300 incl dividends) sustained a fall of 2%, which was followed by larger falls offshore. One catalyst was the new strain of Covid known as Omicron, and although it is not yet fully understood, it is hoped that existing vaccines will provide resistance. The primary driver of the weakness in markets however is more likely to be the more hawkish commentary from the US Federal Reserve.

Our market ended 0.5% lower in November; this was below most offshore markets and took the shine off what had been thus far a stellar year. When looking at comparative performance, the 5% fall in the Aussie dollar was largely to blame. It has been a wild ride for currencies, with emerging markets coming under immense pressure as inflation bites. Turkey recorded monthly inflation of 20% and its President went rogue, deciding that the only way out of it was to fire the finance minister and cut interest rates. This novel approach served only to further weaken the currency and the Turkish Lira has now fallen more than 40% in three months. Brazil is also suffering from questionable leadership with President Bolsonaro claiming "it makes no sense for me to be vaccinated", in a country in which 600,000 people have so far died from Covid.

Inflation continues to be a major concern, with fears that the interest rate policies of many central banks are way behind the curve, i.e. they have not been raising rates quickly enough in order to contain inflation. Fed Chair Jerome Powell took it upon himself to retire the word 'transitory' from his description of inflation and, looking at the chart below, it would be hard to disagree with him.

US Core PCE (Inflation excluding Food and Energy)



Source: J.P. Morgan estimates, Bloomberg Finance L.P.

Commodity markets were rattled in November with more lockdowns re-emerging in Europe and Omicron sparking fears of more. The price of Oil fell 16% while Iron Ore prices (-14%) also continued to languish. Interestingly, Australian iron ore mining stocks gained despite the drop in spot prices as there is increasing conviction that China rhetoric has turned pro-growth. Policy makers in China have clearly changed their tune in recent weeks. We've seen talk of increased bond issuance for construction projects, talk of Reserve Rate Requirement cuts by the People's Bank of China, and now a key policy maker, Liu He, is talking about the China economy's "growth expected to exceed targets".

Portfolio comment

The Fund outperformed the market in November. The most material positive contributors diversified resource company BHP, industrial property specialist Goodman Group, building materials producer James Hardie, dominant supermarket operator Woolworths, and plumbing products manufacturer Reliance Worldwide. Not owning big bank Westpac or credit provider Afterpay also helped returns. The only meaningful detractors were gas company Santos and big bank CBA, although not owning Fortescue or Telstra also hurt a little.

Performance*	1 Month %	Quarter %	1 Year %	3 Years % p.a.	5 Years % p.a.	10 Years % p.a.	Since Inception^ % p.a.
Fund return (net)	0.0	-1.7	18.6	13.5	10.8	12.1	10.6
S&P/ASX 200 Acc. Index	-0.5	-2.5	15.5	12.6	10.1	10.3	9.1

*Returns are calculated after fees have been deducted, assuming reinvestment of distributions. No allowance is made for tax. Past performance is not a reliable indicator of future performance. Source: Fidante Partners Limited, 30 November 2021.
^The Fund changed investment manager and investment methodology on 12 July 2010, at which time Alphinity Investment Management commenced managing the Fund and started the transitioning of the portfolios to a structure consistent with Alphinity's investment views. The transition was completed on 31 August 2010. The inception date for the returns for the Fund is 1 September 2010. For performance relating to previous periods, please contact the Fidante Partners Investor Services team on 13 51 53 during Sydney business hours.

Market outlook

The Australian equity market has essentially gone sideways over the second half of 2021. This of course follows the exceptional run that has taken place in the aftermath of the initial Covid panic in March 2020, and has been supported by an extraordinary amount of monetary and fiscal stimulus.

With a peak in global economic growth rates, despite stubborn inflation data around the world, investors are nervous and central banks are in a quandary: should they focus on addressing inflationary pressures by tightening monetary settings and risk slowing growth further, or should they prioritise economic growth and employment and risk inflation getting out of control? It appears that most central banks, including the most important one, US Federal Reserve (Fed), are inclined more towards the former.

The Fed can of course change its mind at any point, as it famously did in January 2019 when it performed what is often referred to as the 'Powell Pivot', after Fed Chairman Jerome Powell. At that time, the Fed switched from a tightening bias, with a clear timeframe to exit the extremely loose monetary policy that had been in place, to a resumption of easy money. The aim was to address a sharp slump in the US share market and it worked, triggering a strong rally. Things look more difficult this time, however. Most data suggests that inflation is becoming more entrenched, and monetary conditions are already at such low levels that simply leaving them unchanged is really as much as the Fed can do to spur the economy on. This limits the Fed's options to boost growth much further.

Add to this high valuations for most sectors of the equity market, especially for the structural growth sectors like IT and to some extent also Healthcare, not to mention ongoing uncertainty in relation to Covid, and it is difficult to see markets moving much higher in the near term. With a more uncertain outlook for corporate profit growth, and thus Cyclical companies, and less cheap money to support Growth stocks, traditional defensive stocks that have lagged both may see increased support in the year ahead.

Portfolio Outlook

Quarterly aggregate earnings upgrades for companies in the Fund have continued to be positive, much better than for the market overall. We detail a few of these, from different sectors, below.

In the Healthcare space, Sonic Healthcare has continued to benefit from large volumes of ongoing Covid testing at the same time as demonstrating good growth in its underlying pathology testing business. With an almost ungeared balance sheet we expect the company will pursue acquisitions in its core markets before too long. It has a good record of buying and integrating adjacent businesses, so more of the same should support Sonic's medium term growth.

Diversified mining company South32, which has been in the portfolio for some months, is in our view still quite early in its upgrade cycle as its key commodities Aluminium, Metallurgical Coal, and Manganese remain in strong demand. South32 divested the last of its thermal coal operations in South Africa earlier in the year, replacing it with a promising Copper asset.

In the Real Estate sector Goodman Group is a global leader in the development and operation of modern logistics facilities. It is one of the longest standing positions in the Fund but continues to deliver on its large development pipeline, and recently upgraded its full year earnings guidance substantially.

While the overall market is looking increasingly vulnerable to any broader earnings disappointment or a rise in interest rates that might take place earlier than the 2024 the Reserve Bank of Australia has promised, we have continued to diversify the portfolio and increase its bias towards quality companies with the scope to deliver positive earnings surprise: our experience is that the companies able to do this are more likely to outperform. We expect this will hold the Fund in good stead as we enter 2022.

Asset allocation	30 Nov 2021 %	Range %
Securities	96.6	90-100
Cash	3.4	0-10

Top five active overweight positions as at 30 Nov 2021	Index weight %	Active weight %
BHP Group Limited	5.7	4.3
Macquarie Group Ltd	3.4	3.9
National Australia Bank Limited	4.4	3.5
Medibank Pvt Ltd	0.5	2.7
Goodman Group	2.0	2.7

BTW

As fiduciaries of our clients' wealth, we need to not only thoroughly understand the companies in which we are investing but also consider a much more challenging construct, the macro outlook. Undoubtedly, some of the most important factors when trying to assess the macro outlook include inflation expectations and determining what central banks will do with interest rates. And no central bank is scrutinised more closely than the US Federal Reserve, a.k.a. the Fed.

There are three parts to the Fed: 12 regional Federal Reserve Banks based in different parts of the country, a Board made up of the Governors of those banks, and the Federal Open Market Committee which essentially sets short term interest rates. It does this primarily to control inflation, but the Fed's activities are much broader than that, including injecting funds into the monetary system. This is known as Quantitative Easing. QE is often referred to as printing money although there are no actual printing presses rolling out fresh paper bills. In practice the Fed creates money and buys US bonds from the market, ensuring that bond yields stay low. Moves in bond yields have large effects on the valuation of many other securities, including equities, as some investors look for relative value between a company's dividend and bond yields.

Quantitative Easing was originally intended to ensure that the credit it created would move outside the banking system into the real economy, but somewhere along the way the aim seems to have shifted to just keeping rates low. This has had the effect of inflating asset prices and generating a lot of wealth for people who already had assets. We've seen this play out in over-heated housing and stock markets around the world – and don't get us started on crypto!

Currently the Fed is in taper mode, meaning that it is gradually reducing the amount of bonds it buys. This should have the effect of lowering bond prices (i.e. yields rising) as this large buyer takes less out of the market. It had been buying $US120 billion worth of bonds a month but, from November, that is meant to fall by $15 billion each month. Clear communication from the Fed to the market is important and this gradual withdrawal of liquidity has been well flagged and should have been largely priced-in now. But considering that the Fed plays a critical role in stabilising not just the US economy but also many other economies around the world, it is worth asking whether the Fed deserves our trust?

The current Chairman, Jerome Powell, was recently reappointed by US President Biden to run a second term, beating out close contender Lael Brainard. While such continuity has generally been taken positively, the last few months things have been quite tumultuous 'under the hood' as jostling for top job took place. The Fed needs to demonstrate integrity, but it has recently come under the spotlight for a trading scandal involving two of its most senior officials. It has been alleged that one Governor, Robert Kaplan, traded millions of dollars of oil and gas stocks during his tenure leading the Federal Reserve Bank of Dallas, and that a fellow Governor, Eric Rosengren of the Federal Reserve Bank of Boston, traded in securities tied to real estate, a sector which is highly sensitive to Fed Policy. Both resigned following the news of the trading, citing health reasons, conveniently walking away into early retirement.

When you think of all the assets of a Central Bank, its single biggest asset is not even on its balance sheet: that is its reputation. While it is important to note that neither of the Fed officials have been found guilty of insider trading, it certainly served as wake-up call for it to revamp its personal trading rules, and in doing so, help to maintain the credibility on which many global investors rely.

While new trading rules are now in place, it beggars belief that senior Fed decision makers were able to trade in securities with so few restrictions in a period during in which the Bank was taking extraordinary steps to stabilise markets amid the pandemic. Any company operating in financial markets in Australia, Alphinity included, will have very strict rules around who can trade what and when they can do it; one would expect the world's largest central bank to be a the forefront of this sort of governance, not be an undeniable laggard.

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Traveller's Tale

International travel is back and it looks like El Salvador could become the next must-go destination for the rich and famous. During November its President, Nayib Bukele, proposed a new "Bitcoin City" based around crypto currency. Importantly, it will possess a number of attributes universally prized by plutocrats around the world and may end up bringing wealth to a country that has struggled financially for years. Those attributes are shown in the photo opposite, along with Bukele in his signature look, a backwards-facing baseball cap.

El Salvador is a tiny country in central America with about 7 million residents and per capita GDP under $US5,000. Its economy has largely revolved around agriculture, primarily cocoa and coffee, although more recently it has tried to move into finance and light industry. About 20% of its GDP comes from its emigrants sending money back home. For a long time it had its own currency, the unfortunately named Colón, but switched to $US in the early 2000s after a currency crisis. Global markets have taken a dim view of El Salvador's prospects and its $US-denominated bonds trade at a 35% discount to their face value, suggesting serious doubt about as to whether lenders will get their capital back. Clearly more needs to be done to reduce poverty there and Bukele seems to have concluded that crypto is the way to go.

"Mining" cryptocurrency is a notoriously energy-intensive activity. Considering the tight carbon budget within which the world needs to operate in order to keep climate change under control, we doubt that solving complex mathematical equations in order to earn coins is the optimal use of fossil fuel-generated electricity. If the energy used were coming from renewables it might be more acceptable and this is what El Salvador plans. It proposes to build a new city at the base of the Conchagua volcano, near the southern border with Nicaragua. Being close to a volcano makes renewable, carbon-free geothermal power possible so the coins can be generated with less guilt. Of course being close to a volcano could pose other challenges: the recent eruption in La Palma in the Atlantic shows how dangerous volcanos can be. There is no record of Conchagua ever actually erupting, it can't be ruled out given the extent of the thermal activity in the area. That's why they are able to produce carbon-free electricity.

Anyway El Salvador planning to issue $US1 billion worth of "volcano bonds" to achieve this vision, $US bitcoin bonds which will pay a 6.5% coupon. Half of that billion will be used to build the city and power plants and the other half used to buy existing bitcoin, presumably as an investment. The bond has a kicker of up to 50% should there be windfall gains from the bitcoin (no, we don't understand how it will work either). In a world of zero interest rates and miniscule bond yields, 6.5% seems almost too good to be true.

We can't help feeling there are several layers of "what could possibly go wrong?" in the plan. Volcano bonds fall outside the scope of our investment mandates sadly so we won't be able to take any but we're sure a friendly investment banker could help should you feel compelled. As in everything though, we advise caveat emptor!

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