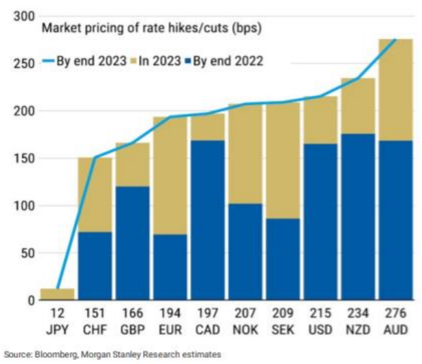
Good to be Bad

Market comment

With pessimism among investors at extreme levels and surveys claiming average cash holdings at 20-year highs, the backdrop was set for a sharp rebound in equities. As it happened, bad economic news turned out to be good for the markets, as growth in both the USA and China disappointed. This led to speculation that future rate rises might be less intense than previously expected, i.e. good for markets. In addition, a 'better than feared' start to earnings season in the US and Europe, and probably a bit of FOMO, sent markets roaring higher.

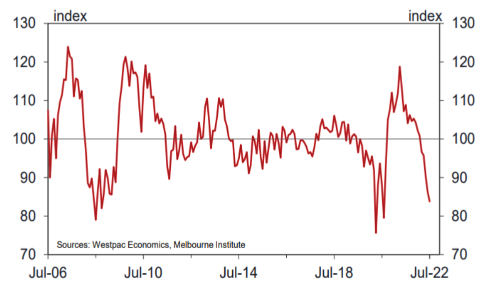
In the US, the S&P 500 index gained 9% in $US (8% in $A) its strongest July return since 1939. Australian shares also bounced back from June's poor performance, although what would normally have counted as a strong month (ASX300 including dividends up 6%) was still a little short of what it lost in June. Along with the US, Japan and Sweden, ours turned out to be one of the better markets in $A terms. Chinese shares in Shanghai fared poorly, falling nearly 5%; Hong Kong was even worse (-8%) while most Euro markets were a couple of percent higher. The $A appreciated slightly against the $US, recouping much of June's losses and finishing at US70c, supported by well-founded expectations of further official cash rate increases.

Interest rate expectations are at the front of investors' minds. The Reserve Bank of Australia is under scrutiny after its "no rate hikes until 2024" thesis didn't quite play out, and it's interesting to see in this chart from Morgan Stanley that Australia has now surpassed the US and New Zealand to be the country with the largest amount of interest rate expectations priced in, with a further 1.5% by December and almost as much again in 2023.



Earnings season is about to kick off in Australia and we have seen in the US and Europe, where a large proportion of companies have reported, that the degree of earnings disappointment many had feared didn't actually play out. Sure, some companies like Snapchat, Walmart and Marky Mark Wahlberg's F45 gyms had massive downgrades, but for the mega cap tech and consumer names, sectors where much of the concern had been building, earnings generally beat expectations.

In the case of economic data, it was "good to be bad". Australian consumer confidence (below, as measured by Westpac) echoed falls in the US, down eight months in a row as the prices of food, energy and rent kept rising. Australian inflation printed at a 6.1% annual rate, the highest level since Australia introduced the 10% Goods and Services Tax in 2000.



Sector performance was largely driven by the fall in bond yields. Technology (+15%) and Property (+12%) were the best performers while recent beneficiaries of rising yields, Energy (+2%) and Materials (-0.4%), underperformed.

Portfolio comment

The Fund lagged the market somewhat in July. Positions in industrial property developer Goodman Group, major banks National Australia Bank and Commonwealth, and not owning gold producer Newcrest Mining added to performance, but these were more than outweighed by holdings in resource major BHP, global insurer QBE, petrol distributor Viva Energy, gas producer Woodside Energy and not owning South 32. However it was another month in which macro moves had an out-sized impact on returns.

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)	4.1	-6.0	-2.9	4.5	8.5	10.9	9.7
S&P/ASX 200 Acc. Index	5.7	-6.0	-2.2	4.3	8.0	9.5	8.3

*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, 31 July 2022.
^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.

Monthly Report – July 2022
Alphinity Concentrated Australian Share Fund

Market outlook

It didn't take long for equity investors to start viewing bad economic news as good news for the market. Signs that the economy is slowing have become more evident, and, while this would normally be seen as bad news, it is increasingly also being seen as a reason for central banks to not go as hard on interest rates. As the pace and size of interest rate increases has been a major headwind to equity returns this year, hints of a slower rate trajectory has in recent weeks been seen as good news.

While we agree that the pace of rate hikes is likely to slow in the next few months, in order for central banks to be towards the end of their monetary tightening regimes economies would need to slow much more than we have seen so far. In other words, the Goldilocks scenario, whereby rates are about to peak and a "soft landing" takes place for both the Australian and Global economies, appears overly optimistic to us.

Last month we wrote that increased concerns over earnings risk in the more cyclical parts of the market would likely lend some support to some of the more highly-valued structural growth stocks. However, the size of the returns we saw in July from some of those stocks is not something we had expected. That unprofitable tech companies should be the winners in a more severe economic downturn, even if that were to put rate hikes on hold, still seems an unlikely outcome to us.

The US company reporting season is largely over and, while there are many differences between Corporate USA and Corporate Australia, the trend so far of companies meeting or slightly exceeding earnings achieved to date – but at the same time seeing future growth expectations downgraded – looks like a plausible outcome here too when our August reporting season gets underway.

All up, even though equity markets have de-rated somewhat so far in 2022 thus removing some of the risk to the downside, to give the all-clear for sustainably higher equity markets while inflation remains high and still out of sync with interest rates, at the same time as corporate earnings may still have meaningful downside, seems ill advised.

Asset allocation	31 July 2022 %	Range %
Securities	97.5	90-100
Cash	2.5	0-10

Portfolio Outlook

The turn in sentiment during July, resulting in previous winners being sold and losers being bought, was challenging for the relative return of the portfolio considering its exposure to companies experiencing positive earnings revisions and with above average quality in terms of cashflow and profitability.

This type of market event is unusual and generally requires a change in earnings leadership in order to be sustained. While our overall thinking is that negative earnings revisions in aggregate are likely to persist for some time, and will predominantly occur in companies that are already experiencing such revisions, changes can take place for multiple reasons at both the company and sector levels, as well as more broadly, and we will continue to monitor for any changes in the earnings outlook at all these levels.

For example, it is clear that the global economic slowdown, combined with cost escalation, is making it more difficult for most commodity producers to deliver earnings ahead of market expectations. We have therefore continued to trim our exposure to the Resource sector. China, and its endeavours to stimulate its economy in order to not fall too far behind its annual growth target, remains something of a wild card but even its usually impactful Government directives might turn out to be more difficult to implement this time. This is not only due to ongoing Covid restrictions in China, with its zero-Covid policy still in place and a lower level of vaccination than many other large countries, but also due to a severe drop in consumer confidence which could take some time to reverse.

At this stage, new earnings leadership appears more stock-specific than sector or industry based, and the upcoming reporting season should provide helpful insights for how things will develop. The overall direction however still suggests that defensive stocks will continue to dominate. The portfolio, while still well diversified, increasingly reflects these observations.

Top five active overweight positions as at 31 July 2022	Index weight%	Active weight %
National Australia Bank Limited	4.8	4.1
Commonwealth Bank Of Australia	8.4	3.8
Woodside Energy Group Ltd	2.9	3.3
Woolworths Group Ltd	2.2	3.0
Medibank Pvt Ltd	0.5	2.9

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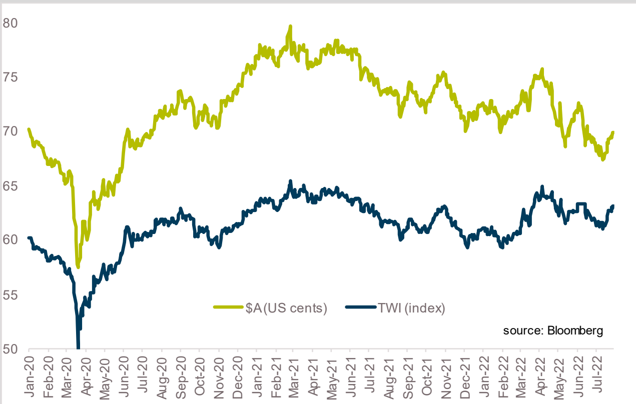
BTW

The $A has been remarkably jumpy since Covid appeared. It was trading at US70c when the first cases appeared in Wuhan, and then the dawning realisation of the economic impact of a global pandemic sent our currency tumbling. It fell below US60c in March 2020 before recovering strongly, hitting US80c in February 2021. Since then it has gradually trended back down – with a few bumps along the way – and at the end of July it was 70c again. So a lot of mucking about for no net change in two and a half years.

There is more to life than the $US however. The Trade Weighted Index (TWI) assesses our currency relative to those of our major trading partners. The TWI chart looks remarkably similar to the $US chart, which isn't that surprising as some of our trading partners have currencies with some linkage to the $US: China, for instance, represents ~37% of trade but China doesn't have a free-floating currency like ours, it is loosely pegged to the $US. The $US itself, the Euro and the Japanese Yen each represents about 9%; Korea's Won about 5% and the UK Pound about 4%. Those top six constitute about three quarters of the index. Against the TWI, our currency has actually appreciated by about 5% over the period, from 60 to 63.



That tells you about the price of the currency, but not much about its value, i.e. what it can buy. While the pricing of a currency reflects the balance of buyers and sellers at a point in time, currencies can, and do, get out of whack. You really need an impartial measure to see whether a currency is over- or under-valued.

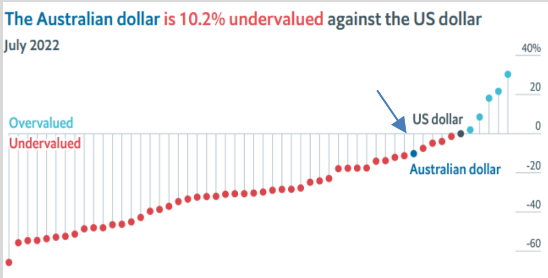
Back in the 1980s the Economist magazine came up with a light-hearted way of estimating currencies' purchasing power parity by using a product which is the same the world around, despite being domestically produced in each country: the McDonald's Big Mac.

McDonalds takes pride in the consistency of its products around the world despite the challenges sometimes involved in locally-sourcing things like the pickles that are routinely removed from the billions of burgers it makes each year around the world. The Economist takes pride in its [Big Mac Index](). It even has an apt abbreviation, BMI.

The Economist looks at the price of a Big Mac in each country and converts it into $US. It then compares prices in different countries to arrive at a view of how "cheap" or "expensive" a currency is trading. For example, even though the Swiss Franc and the $US are worth about the same on the foreign exchange market, a burger will cost you Sfr6.50 in Switzerland versus $US5.15 in the US, suggesting the Franc is about 30% over-valued. The Nordic countries are also over-valued but by a smaller amount, around 10%. Not surprisingly, a Big Mac in Canada is very close to parity with the US but most currencies end up looking quite cheap against the $US.

There are some substantial anomalies as you go further down the list. The most extreme is Venezuela, where 10 bolívares (<$US2) will buy you the big burger at the Caracas Maccas. A bargain price perhaps but we suspect it reflects the dire economic situation there. Less easy to explain is prosperous Taiwan, where a Big Mac costs NT$75, and economic powerhouse Japan's ¥390. Both convert to less than $US3, 40% below the price in the US. Other anomalies include Egypt, India, South Africa, Indonesia and Romania, whose Big Macs are all priced about 45% below what they should be on to the BMI.

So where does the $A sit? $US5.15 at a 70c exchange rate is $A7.35 but the price of a Big Mac in Oz is a mere $A6.70,



suggesting that the $A is about 10% undervalued. Equally, $NZ7.10 in New Zealand undervalues the $NZ by about 14%. We suspect, however, what it's really saying is that the $US is way over-valued, not that (almost) all other currencies are cheap.

Monthly Report – July 2022

Alphinity Concentrated Australian Share Fund

Traveller's Tale

Andrey went to London in July and low expectations, that time-honoured recipe for positive surprises, served him well. Going into the trip expecting a nightmare of flight cancellations and endless Covid travel forms to complete, Andrey was pleasantly surprised by only moderate flight delays and an immigration/luggage wait time of less than three hours at Heathrow. The only Covid restriction he saw was the need to wear masks on planes, but there is no requirement for PCR or Rapid Antigen tests or any need to submit online forms to get into the UK itself. Outside the airport, most people went unmasked.

Xerocon 2022

The primary purpose of Andrey's trip was to attend Xerocon, the annual conference for accounting software company Xero users, although he also had a number of other meetings with technology and industrial companies. Just as Berkshire Hathaway refers to its annual shareholder meetings as "Woodstock for Capitalists", Xero calls Xerocon "Glastonbury for Accountants", a reference to the UK equivalent of Byron Bay's Splendour in the Mud. While a conference of accountants might seem less than exciting to some people, Xero adds pizzaz by offering entertainment like dodgem cars, ball pits and celebrity speakers.

The 40ºC heat wave in London was a welcome respite from the rainy Sydney winter he left behind, and London in summer can be magical. There's lots going on to distract you from work, and when the weather is good those long evenings bring people out in force. Pubs were overflowing from midday to midnight, and there were scores of Londoners keen to beat the heat by consuming a few pints standing outside.

At the same time, most offices were empty – correlation not causation of course. Many office workers made excuses to save themselves from coming to the office, the most common being wide-spread train strikes which made it difficult to get to the City. Yet the pubs were full. Andrey had to conclude from this that pubs in the City must have their own dedicated train lines!

For further information, please contact:

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