Alphinity Concentrated Australian Share Fund

MONTHLY REPORT – MAY 2023

Raising the Roof

Market comment

While almost becoming a sideshow to the AI boom, risk in markets during May centred around the US Congress as it negotiated a raise in the debt ceiling, the maximum amount of debt the US government can incur. This is not a new issue, after all Congress has increased the ceiling 78 times since 1960, but there is a period of instability in markets as the risk of a US default looms, driven by political agendas to force spending cuts. Markets have historically tended to look through this risk of default, and it was shrugged off again this time too as an agreement was shaping up by month end.

It does appear though as if equity markets have been dancing to their own tune, with global and US markets gaining every month so far in 2023. And where did the volatility go? It seems almost implausible given the various signs of weakness in the economy and our own cost of living pressures here in Australia that equity markets are pricing in very little risk. In addition, the US is in the midst of a trucking / freight recession, a clear sign the goods economy is in trouble (see the BTW). Despite these risks, equity markets continued to grind higher and the VIX Index, a commonly used index to measure risk in equities, keeps falling to low levels.

Undoubtedly, while some of the move higher in May was driven by gains in tech stocks, this conundrum of low risk can explained by a few factors, one of which is the positioning of various types of buyer and sellers, this is what makes the market after all! Lower volatility is usually accompanied by lower trading volumes, and this has certainly been a factor this year. Quant-based funds have been buying while larger institutions have been content to sit on the sidelines, evidenced by higher cash levels on average. As the market grinds higher, these larger institutions, pension funds and the like, are often forced to reduce these cash levels to improve performance, often called 'chasing the market'.

Following on from our concerns last month around the lack of breadth of returns in the US market, May was no different. In fact, it became even more concentrated around the mega cap Tech stocks and any company with even the most remote connection to AI performed well.

Nvidia delivered one of the largest earnings upgrades in history, with earnings forecasts up a staggering 65% and the company joining the likes of Apple and Microsoft in the "1 Trillion dollar club" of market value.

Australian equities underperformed given the Tech rally was the only game in town, while Materials and Energy stocks weakened on China softness and underlying recession risks which held back oil prices. The S&P/ASX 300 index fell 2.5% including dividends, underperforming global markets, especially the US Nasdaq that rallied 8.4%. The broader S&P 500 index closed up 2.5% in AUD terms. Japanese stocks have also been strong performers, up 18% so far in 2023 on the back of the Government's push for improved cash allocation and greater focus on profitability. Recent research trips to China confirmed reasons to remain cautious on recovery there as they come out of Covid. With contracting manufacturing data in two consecutive months, the hype around re-opening hasn't played out, and there has been a marked shift in investor flows out of China and into countries like Japan.

If you look at Australia as a market, comprised largely of financials and resources stocks, then both ends of this barbell came under pressure, and with the consumer sector also weaker, there wasn't a lot of places to hide outside of Tech. Consumer Discretionary (-6.4%) and Financials (-4.7%) were the worst performers, while Materials also fell 4.5%. Technology stocks were the clear outperformers, the group rising 10.4% with Utilities closing marginally higher.

While inflation is cooling in US and in Europe, the headline Aussie CPI print of 6.8% in April (vs 6.4% expected) did little to re-assure consumers, investors and homeowners that the RBA has won its fight on keeping a lid on prices. According to Governor Lowe, we just need to work harder, spend less and live in communes to ease the housing rental crisis…easy, thanks Phil!

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)	-2.8	-1.9	2.6	11.2	7.0	9.1	9.6
S&P/ASX 200 Acc. Index	-2.5	-0.9	2.9	11.4	7.5	8.1	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, 30 November 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.

Portfolio comment

The Fund lagged the market a little in May, with a holding in respiratory products maker Fisher & Paykel and not holding accounting software provider Xero both detracting from returns. The portfolio benefitted from no exposure to Wesfarmers and gold miner Newcrest, while overweight holdings in CSL and Lynas Rare Earths also contributed to returns.

Market outlook

At the end of May the Australian equity market was trading at slightly below its long term average forward earnings multiple of 14.5x. With only a month left of FY23, earnings growth for the whole market is now estimated to be around 3-4%, with a similar outcome expected for FY24. While these are below the typical 6-7% historical earnings growth rate, even this low rate may prove optimistic for the year ahead considering the Australian and global economies should continue to slow after the aggressive interest rate increases over the last year or so.

Both the Reserve Bank of Australia and the US Federal Reserve are now probably towards the end of their respective rate-hiking cycles but, in our view, economic data would need to become significantly worse than currently expected by most market observers for either to start looking to cut rates in order to stimulate economic growth. Falling rates has typically been required for more sustainable equity market gains in a low growth or contracting economic environment.

Consumer spending does appear to be on the cusp of a more meaningful slowdown, having shown surprising resilience since rate hikes begun. This should please the RBA but, at the same time, house prices have moved up in recent months, which suggests policy makers may have more hikes in store.

For Australia, as always, aggregate earnings growth will be influenced by China's economy and thus commodity prices, and Chinese economic growth has been tepid so far this quarter. While partly an effect of demand having been pulled forward into the March quarter, as that country came out of lockdown, growth would need to pick up in the second half of the year in order for commodity prices to not risk sliding lower. This will likely require the Chinese Government to step in with more stimulus measures, which it has typically been quite willing to do. However, the high aggregate debt levels there, not to mention local governments' constrained ability to underwrite property and infrastructure projects with land sales, are likely to constrain the size of future stimulus measures.

The global AI frenzy has not fully bypassed the Australian equity market but, with limited genuine earnings leverage to this thematic, traditional earnings and market drivers are still likely to determine market returns in F24. At this stage, the typical 8-9% total equity market returns could be achievable but look to be on the optimistic side.

Portfolio outlook

In a market with limited overall earnings growth and earnings revisions that, despite some stabilisation more recently, appears to have more risk to the downside than upside, companies which can deliver growth, and especially growth ahead of market expectations, should be well rewarded. The Fund remains well exposed to these types of companies overall and we look forward to confirmation of this as we approach the August reporting season.

During May we further reduced our Bank exposure as increased mortgage competition and higher funding costs will be a challenging combination for the Banks' net interest margins, especially in a low credit growth environment. We remain less concerned about large credit losses for the banking sector as a whole given large unused provisions that were raised during the Covid period. A moderate underweight to the sector is appropriate, in our view. We have also reduced our exposure to the Resources sector in face of weaker economic data out of China. We remain firmly underweight that sector in aggregate with a maintained preference for iron ore exposure, albeit at lower levels.

We have however built positions in James Hardie and Cochlear during the past months. We previously had concerns with Hardie's ability to manage margins and continue taking market share in a soft US house siding market that is increasingly competitive. While the overall market environment remains challenging, housing starts have stabilised at lower levels in recent months. More importantly however, James Hardie has managed the weak environment well from a cost and sales perspective resulting in a better than expected margin outlook and likely further earnings upgrades.

Cochlear is benefitting from the dual tailwinds of a post-covid recovery in implant surgeries and the successful launch of its latest generation sound processor, the Nucleus 8. Processor upgrades are typically released every five years and the latest version, which is smaller and has better connectivity than its predecessor, should enable Cochlear to not only gain share of new patients but, importantly, also trigger strong demand from N6 and N7 users that will now be eligible for an upgrade, funded by their health insurers.

Top five active overweight positions as at 31 May 2023	Index weight %	Active weight %
Brambles Limited	0.9	3.2
Medibank Pvt Ltd	0.5	3.1
Aristocrat Leisure Limited	1.2	2.9
QBE Insurance Group Limited	1.0	2.8
CSL Limited	7.1	2.8

Asset allocation	31 May 2023 %	Range %
Securities	97.4	90-100
Cash	2.6	0-10

BTW

While Covid-19 is already starting to feel like a distant memory for some, the effects on the supply chains of goods continues to be felt across the global economy. At the start of Covid, there was an expectation that consumers wouldn't buy much so some retailers and manufacturers cut back on orders. In reality however the 'stay-at-home' consumers bought a lot and companies had to scramble to meet demand and build up inventories. We are seeing the reverse.

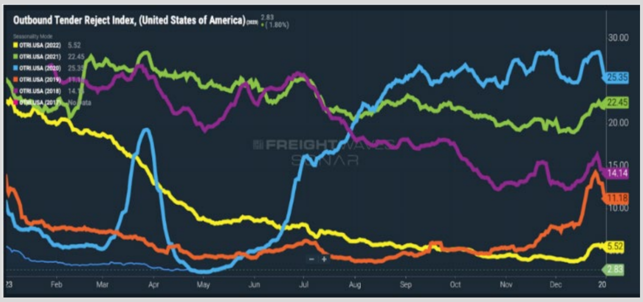
While terms like 'revenge travel' have been coined to symbolise the surge in post-Covid demand for overseas holidays, the opposite effect is being felt in the freight industry, where the movement of goods has substantially slowed. Companies with pricing power have been raising the price of goods to compensate for lower volumes, which isn't a great indicator for the truckers responsible for moving around these products as they rely on volumes of freight.

It may come as no surprise that the US trucking industry is in the midst of a 'freight recession', but how did we get here and how long will it take to come out of this? How we got here was largely a result of a shift in consumer spending during Covid. As a result, there was a big shortage of trucking capacity and the thing with trucks is that there are almost zero barriers to entry, compared to airlines for example. At its peak, truckers could make USD4 per mile, which roughly translates to USD350-400k per year without any formal training / education. This led to a 28% increase in dispatchable capacity from 2019 to 2022, according to data compiled by Freightwaves.

To get an idea of how long it will take the Trucking industry to recover, various indicators suggest it will likely to be some time before we see a turnaround. Of the larger fleets, most companies built up strong balance sheets over the last 2 to 3 years, and there hasn't been the usual number of bankruptcies that are usually seen as the market bottoms. Unfortunately, the reality is that we probably wont see a bottom in this cycle until there is a real wash-out, which means many more firms exiting the industry. In terms of the capacity issues, the news isn't great either. At the Covid peak, there were 8,000 – 9,000 new fleets entering the industry per month and this went on for 14 to 16 months. Currently, there are only 2,000 – 3,000 fleets leaving the industry per month, so it will still take some time for the excess capacity to come out.

One of the best indicators to measure the health of the US trucking industry is to look at how much trucking fleets reject load requests.

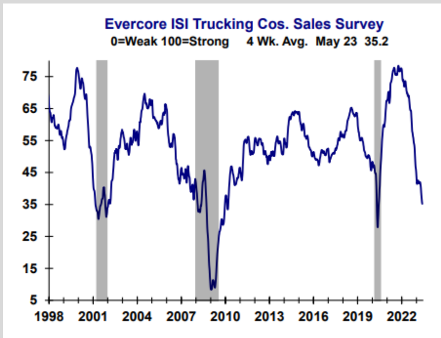
USA Outbound Tender Reject Index



The tender reject index produced by Freightwaves shows the faint blue line at the bottom of the chart at 2.8% so far in 2023, meaning that trucking fleets are rejecting only 2.8% of all load requests. Its an interesting chart as it also shows the huge upward lift in 2020 up to a rejection rate of 25% during Covid. This was both supply and demand-driven, where it was impossible to hire new truck drivers while at the same time demand for consumer goods increased well beyond expectations.

The US freight industry is waving red flags about a possible history-breaking downturn, with one CEO recently saying that current conditions in the industry are reminiscent of 2009, which was the longest and most brutal freight recession of the 21st century.

Evercore ISI Trucking Survey



In addition to the Freight -waves data, Evercore's monthly trucking survey (dark blue line) continues to follow a downward trajectory, declining in eight of the last nine weeks.

Perhaps you are wondering why this discussion of US freight and trucking is important? Its not the most captivating dinner party conversation (this we can attest to!). Given recent advances in capturing high frequency trucking data, this usually leads more traditional macro indicators by 4 to 6 months and gives us a good read on the health of the consumer spending and even possible broader recessionary outcomes. While it currently seems limited to consumer packaged goods (auto still doing ok) the freight recession is probably necessary to help bring down inflation and take some pressure off rate hikes. As always, the landing path will be critical.

Traveller's tale

Our global portfolio managers were as usual globe-trotting in May, visiting companies around the world and gaining valuable insights that help feed our investment process. Mary went to China, while Jeff and Chris both went to Europe visiting more than 50 companies between them in less than two weeks. They had a day of cross-over in Paris, but sadly no time to catch some of the tennis at the French Open.

Trent, Alphinity's global PM covering Tech decided he needed a mini-break from the roller-coaster ride of US Tech investing so he embarked on a two-day trip to Melbourne's Urbn Surf. One can't help noting the similarity between riding the wave of AI stocks and getting your head smashed by your own surfboard on a real wave. Just out of shot was the monster Nvidia wave swallowing up everyone in its path. Just keep riding that AI wave!

Before

After

While Trent was ducking waves and dodging surfboards, Mary was gaining valuable insights on the ground in China and Hong Kong. Much has been made about the demise of Hong Kong and the concurrent rise of Singapore as the heart of the financial industry in Asia. These stories are greatly exaggerated. Hong Kong is booming with a renewed energy after 3 years of lock downs.

The Alphinity Global Fund currently has no direct investments in China, but the fund does have considerable indirect exposure via MNCs like LVMH, Starbucks, L'Oreal, Otis and Linde. LVMH has been one of the largest positions in the Alphinity Global Fund and has been a strong contributor to alpha over the last 12 months.

Given the remarkable outperformance of the luxury sector, part of Mary's trip was to form a view on the outlook for the sector from here. Are the best days in the past? Over the course of 2 days she visited over 20 different luxury stores in Shenzhen and Hong Kong - Dior, Louis Vuitton, Gucci, Balenciaga, Bottega Veneta, Burberry, Prada, Miu Miu, Fendi, Tiffany's, Cartier and Rolex. Must be fun to cover the luxury sector!

Her view is that demand for luxury goods in China continues to be strong. This cohort is ultra-rich and is largely insulated from the macro uncertainties plaguing other less wealthy cohorts of Chinese consumers.

The outlook for luxury and masstige consumption in the US is a more pressing risk than normalisation of luxury sales in China.

EVs are another global sector with significant exposure to China. Mary visited BYD and Tesla showrooms, visited local EV charging stations and met with management of Pony.ai, China's largest EV robotaxi company.

Tesla's erratic approach to pricing seems to have taken a toll on demand. Consumers are choosing to wait and see if prices go down further before they commit to a purchase, which is a negative for both Tesla and its EV competitors. The roll out of EV infrastructure is impressive with the Minle Charging Station in Shenzhen boasting almost 700 rechargers in one location.

On Pony.ai robotaxis, Mary says "Call me old fashioned, but I prefer drivers in my cars!" Pony.ai as a company is impressive in that it has achieved Level 4 Autonomous Driving (AD) technology much faster than Google's Waymo or GM's Cruise. However, from a behavioural perspective, driverless cars will take some getting used to before widescale adoption in China or anywhere else.

The Alphinity Global Fund has no direct exposure to EVs, but Global Sustainable Fund has a position in EV battery maker Samsung SDI. If the demand for EVs in China deteriorates from here and battery capacity keeps ramping in the US due to the tax incentives provided by the Inflation Reduction Act (IRA) the price of batteries will likely suffer. This is the key dynamic to monitor going forward.

Finally, Mary attended the Morgan Stanley 2023 China Summit to get an update on the Big Tech stocks in China. Alibaba appears to be a darling of yesteryear. There is considerable uncertainty about the long-term growth trajectory of the core e-commerce business and investors are worried about the ability of the company to execute the restructuring IPOs at the valuations the market expects. Gaming companies like NetEase and Tencent, as well as AI beneficiaries like Baidu, have a considerably better outlook than the Chinese e-commerce stocks.

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