Alphinity Australian Share Fund

MONTHLY REPORT – OCTOBER 2023

It's Bad to be Good

Market comment

October has the reputation of being a poor month for equity markets, probably because the two biggest dislocations ever happened in Octobers: the Crashes of 1929 and 1987. That perception is not borne out in fact, however, with 58% of the Octobers since 1928 delivering positive returns, but October 2023 was definitely down. Everywhere. We again find ourselves with the investing conundrum that Good (i.e. strong economic data) means Bad (for equity markets, as interest rates will need to stay high). Our market (ASX300 including dividends) fell by 3.8%. Although in $A terms this was better than a few markets, like New Zealand (-6%), Korea (-5%) and Canada (-4%); it was not as good as China, France and Germany (-2%) or the US (-0.5%). But there are no positive numbers there, despite the $A losing 1.5% of its value.

Economic news was a little confounding during the month. The US economy grew at an annualised rate of 4.9% in the third quarter, higher than expectations of 4.5%, and this kept upward pressure on bond yields. After strong US inflation figures, the Governor of the US Federal Reserve Bank (Fed), Jerome Powell, seemed to put a dampener on any prospect that rate cuts in the US were imminent; in fact, he left the door open for further rate rises should inflation not continue the moderating path it had seemed to be on. Then, at the end of the month, Powell prevaricated, as central bankers are wont to do, saying: "We're not confident we haven't [raised rates enough to rein in inflation], but we're not confident we have". When Australia's September quarter inflation data was released, a small up-tick from 5.2% to 5.4% suggested that inflation here too is stubbornly high and that the Reserve Bank might need to put another nail in the coffin of the consumer by lifting rates one or two more times. Here too, the optimists who expected lower rates early in 2024 are now delaying those expectations until much later in 2024 – maybe even 2025.

Sector performance in October was quite poor across the board. Utilities was the only sector to close higher, although with only three companies in that group it wasn't much of a win. Not surprisingly, all the usual suspects that are hurt by higher rates were the worst performers: Tech (-7.4%), Healthcare (-7.1%), and REITs (-6%). Materials however didn't fall by as much, driven largely by moves in the price of Iron Ore. With increasingly positive chatter around China and its low steel inventories, Iron Ore found support, with the spot price gaining another 1.6% to close at $US119 per tonne.

Apart from Iron Ore, commodities more broadly weakened with oil falling 6% to $US85 a barrel, although to put this move in context, it is still 20% higher than its lows at the end of May. Oil prices usually increase during times of geopolitical risk, and after the tragic events that unfolded in Gaza, there was a brief spike on fear that Iran would become more actively involved, although concerns over macro growth soon offset this. It's a strange time in markets, where commodities are falling, rates are rising, and yet economic growth and the jobs market remain healthy. This disconnect rarely lasts long and, although it's not something we'd wish for, it often takes a recession or some big economic shock to reinstate the normal correlation between the economy and stock markets.

Portfolio comment

The Fund performed in line with the market in October. The best performers were retailer Super Retail Group and health insurer Medibank Private; not owning lithium play Liontown Resources was also positive. The most notable detractor was not owning iron ore producer Fortescue Metals, although positions in industrial companies Brambles and Orora also both held back performance 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)	-3.8	-6.2	2.2	8.8	7.2	6.8	8.4
S&P/ASX300 Acc. Index	-3.8	-7.3	2.5	8.7	7.2	6.6	7.7

* 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 October 2023.

^ 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 2011. The inception date for the returns for the Fund is 1 September 2011. For performance relating to previous periods, please contact the Fidante Partners Investor Services team on 1300 721 637 during Sydney business hours.

Market outlook

While companies' earnings announcements have been having more of the expected impact on stocks in Australia so far this financial year compared to last, volatility in long bond yields continues to dominate market headlines and impact sentiment, and that is likely to persist for some time, in our view.

While the equity market has at times chosen to look through the big bond sell off this year, the longer yields remain elevated, the harder it is to ignore. Without a meaningful economic downturn on the horizon, 'higher for longer' is now increasingly seen as the most likely outcome into 2024 and, as such, the equity market is starting to price it in with more conviction. That provides something of a headwind to future overall market levels, as higher discount rates leads to lower valuations, all else remaining equal.

While we can debate the reasons for, and sustainability of, higher long bond yields – including better economic growth for longer; sticky core inflation; increased issuance from governments funding deficits; and quantitative tightening – the reality is that, in the absence of any improvement in earnings outlook for the market, there has been a growing disconnect between bond yields and equity market valuations.

While the first chart → suggests market earnings multiples are largely in line with long term averages, when you compare the earnings yield of the equity market (i.e. the inverse of the Price/Earnings ratio) to the 10-year bond in the second chart → (where the lower the line, the more "expensive" is the market) the Australian market starts to look on the expensive side. We have no particular insight as to whether bond yields will move materially higher from current levels, after what has already been a very big move, but in order for a greater focus on earnings to be the key equity market driver, we probably need some sideways movement in yields for a while. And for the equity market to move sustainably higher, the overall earnings outlook also needs to improve. This is something of which we are yet to see much evidence.

On top of this, and with seemingly increased regularity, geopolitics is never too far from providing a challenging backdrop to market moves. Looking forward, this environment unfortunately appears no different with a marked increased risk of wider Middle East tensions likely to continue to provide market volatility for some time. While movements in the oil price (and any subsequent flow through to inflation) is the most obvious or direct link for us here in Australia, it does risk a broader impact on sentiment over time.

Asset allocation	31 Oct 2023 %	Range %
Securities	99.6	90-100
Cash	0.4	0-10

Finally, while western economies so far this year have held up better to date and China has fared worse than expected, it does seem like some of China's economic risks are receding a bit. While the 'big bazooka' of economic stimulus has not yet emerged, a number of policy measures have been announced there to keep its economy going along OK, and there will likely be more stabilisation measures to come. We might not see the good old days for some time, but middling growth may be fine for Australia, and much better than some concerns of a few months ago.

The iron ore price continues to be resilient and, along with stronger oil prices, is starting to turn Australian market earnings revisions around from negative to slightly positive. While there is some evidence that underlying Australian earnings have been suffering more than offshore from a revisions perspective, it is not all doom and gloom. Earnings upgrades in energy and mining stocks in a weak overall market could provide some support. We have also seen the consumer hold up better than many expected, with some upgrades coming through for likely 'less worse' outcomes, and enough pricing power in general appears to be maintained to help offset increased costs for now. Earnings revisions might not be positive but thus far there is no earnings 'cliff' to speak of, which is giving the market some hope.

Portfolio outlook

While one can't ignore the broader macro backdrop, which has had outsized impacts over the last couple of years, we continue to find that focusing on individual company outcomes and earnings drivers is the key to generating performance over time. Individual company earnings are obviously the constituents of total market earnings, and that is what will drive markets over the long term. That has come to the fore so far in the current financial year after largely being absent since the Ukraine war broke out almost two years ago. Following a strong reporting season that was centred on strong earnings outcomes for the companies in the portfolio, relative positive momentum has continued despite the bond yield and geopolitical headwinds.

While the portfolio remains reasonably defensively biased, given earnings leadership has tended to be in those companies with resilient earnings and strong pricing power, we have made a number of moves lately that have had a more cyclical bias, following earnings upgrades of individual companies. We have added to the Fund's Energy position as the oil price has held up well. As some of the economic risks in China recede and the iron ore price has remained very resilient, we have added to Iron Ore-exposed companies, BHP and Rio Tinto. Spot prices remain well above forecasts into 2024 and are they likely to see further earnings upgrades ahead. We have also added somewhat to the Fund's Energy position as the oil price has held up well due to low inventories with potential for a spike should the Middle East situation escalate.

Top five active overweight positions as at 31 Oct 2023	Index weight %	Active weight %
Aristocrat Leisure Limited	1.2	2.6
Medibank Pvt Ltd	0.5	2.5
QBE Insurance Group Limited	1.1	2.3
Brambles Limited	0.9	2.1
Goodman Group	1.7	1.9

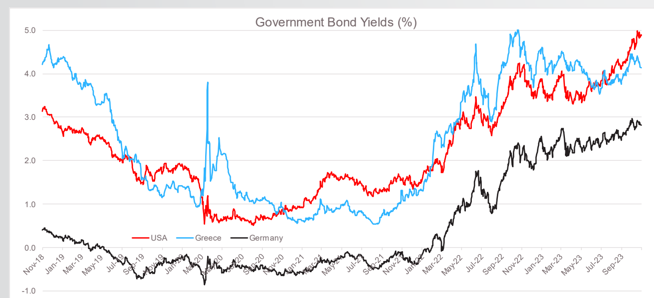
BTW

We equity people sometimes look down a bit on bond investors as being dull and tedious. Most of the time it seems that way: bond yields seem to move at snail's pace compared to the much more exciting equities, and when the bond market does become exciting that's generally when you don't want to be anywhere near it. Bonds are often considered a stabilising part of one's investment portfolio, not an asset class you go to actually build capital, like equities. After all, it is a bond's very nature to pay back your capital on maturity: no more, no less. You get a regular coupon along the way but that's it. There is no opportunity for capital gain if you hold a bond to maturity. Their values can move around a lot in the time between issuance and maturity though, and there are vast numbers of smart people out there trying to trade and make money on shorter-term yield shifts. But on maturity, you will still only get your capital.

Something odd happened in bond markets in October, although not in the part of the market you would normally expect to see strange events, like junk bonds or corporate debt. You expect wild moves when investing in debt issued by high-risk companies, but this was in government bonds (a.k.a. sovereign bonds): debt issued by countries. In most developed markets, government bonds are perceived to be safer than those issued by companies and therefore generally trade on much lower yields. Despite its intractable deficits and a debt limit that constantly needs to be increased, US Government debt is still thought to be the best of the best – "safe as houses", right? Surely they must be less risky than debt issued by fiscal basket cases like Greece?

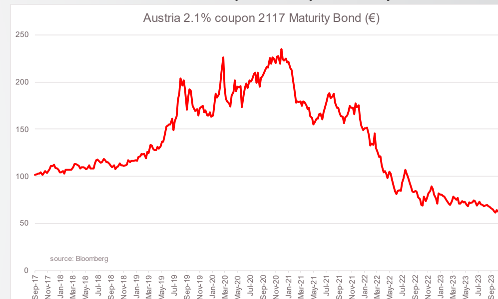
Between 2011 and 2013, several southern European countries suffered debt crises: they had accumulated debt that exceeded what could reasonably be repaid by them. At several stages it appeared that Greece could even default. While this seems to happen on a routine basis in some parts of the world – primarily in Africa and South America – it had never happened to a member of the European Union (EU), and the implications for the rest of the EU were dire. It led to some rather ugly scenes between elected officials of EU countries on opposing sides: the prudent, thrifty Germans saying: "you shouldn't have borrowed so much" and some Greeks leaning on nasty historical tropes, suggesting it would be fine if all the gold Nazis had stolen from Greek vaults during World War II were returned.

Greek ten year bonds reached the staggering yield of 35% in 2011, and it took guarantees and a bail-out from the EU to keep the country from defaulting. How times have changed! Greece's finances aren't all that much better now than back then but their bond yields certainly are: at the end of October a Greek 10 year bond yielded just 4.2%. This compares with US Treasuries of the same maturity of almost 5%. German 10 year Bunds are yielding just under 3%.



Bond Investing 101 tells us that yields move inversely to prices: when yields rise, the value falls. So with a higher yield, US bonds are currently cheaper than even Greek bonds, inferring higher risk. One factor that had led to these moves has been the simple dynamic of supply and demand. Supply is huge: with massive ongoing deficits, the US is forced to issue more than a trillion dollars of bonds every year. At the same time, demand is soft. Japan and China – traditionally large holders of US bonds – have been divesting to help shore up their own financial situations and protect their currencies. But the biggest culprit is probably the US itself. Its central bank had been undertaking QE (quantitative easing) to keep rates low and ease liquidity conditions. This entailed monetary creation, which was used to buy US assets, particularly bonds. Now that the Fed has moved from QE to QT (quantitative tightening), the largest buyer of US bonds has left the room. Recent US 10 year bond auctions have attracted only weak demand which has pushed yields even higher.

Although 10-year bonds are generally the benchmark, countries issue securities with many tenures: from 90 days to 30 years. Or even longer: Austria has issued two series of 100 year bonds in recent years; Ireland and Belgium has too. Anyone buying a 100 year bond is either expressing great confidence in the future or committing an act of gross naivety which is destined for tears at some point – probably several points – during its tenure. This chart → shows the price (not yield) of the Republic of Austria 2.1% coupon 2117 maturity bond from 2017. It was issued before the Covid period during which bond yields became stupidly low, even negative in some places. A hundred-year tenure provides huge moves in value to changes in yield, and the 2117 bond's €100 face value traded as high as €240 in November 2020. This would have been a great time to sell. With the resurgence in global yields since then the value of that bond had fallen to a mere €60 at the end of October, down 40% from issue and 75% from its peak. Not a great outcome for what's meant to be the "stabilising" part of one's portfolio! It's more akin to what you might have experienced in a tech stock or a SPAC. Maybe the bond is a good buy here though? After all you are guaranteed to more than double your money if you sit on it until maturity. Unfortunately, maturity is still 93 years away – well outside the horizon of even most long term investors. More likely, it would be your great-grandchildren reaping the eventual reward. Providing Austria is still around and solvent in 2117 of course. A lot can happen in 93 years.



What about Australia? While we usually have higher yields than the US, reflecting the country's capital needs and the perceived higher risk of our economy, Australian bonds presently yield the same as the US. At the same time, our cash rate of 4.1% is well below the US's 5.5%; again Australia has traditionally had much higher rates. This at least partly explains why the $A has been falling over the course of this year, trading down to multi-year lows. We suspect the cash rate differential might reduce somewhat before long.

Traveller's Tale

Despite 2023 drawing towards a close, there is no sign yet of Alphinity's Global Equity team getting a break from their hectic schedule of overseas travel. As discussed in many previous issues, the insights our team can glean by visiting companies and talking to management on the ground is invaluable.

Global PM Jeff recently visited Sao Paulo and Mexico City to meet with a wide variety of companies in a number of different sectors, including Mercadolibre, Walmex, Santander, Banorte, Vale, Hapvida, PagSeguro, BB Seguridade, Bradesco, XP, BTG Pactual, Itau-Unibanco, Rumo and Ambev. With such a hectic schedule, there was no time to drink Tequila or play beach volleyball, but it was a great opportunity to visit two of the strongest growth stories in emerging markets today, notwithstanding the challenges of braving San Paolo traffic and domestic air travel on the indigenous airline, Latam.

He was almost part of an international incident on one Latam flight when Jeff's passenger insisted he move so the passenger's girlfriend could take Jeff's seat. Unfortunately, this happened during take-off and, after Jeff politely refused, he had to endure a rather awkward time with an aggressive neighbour, the intensity made worse by passengers having been packed into the cabin like sardines. Thankfully, he survived that flight and made it back to Oz in one piece. With the benefit of perspective, maybe Qantas isn't that bad after all.

With 216 million people Brazil is the world's seventh most populous country, and Sao Paolo's population of 22 million makes it the largest city south of the equator. While political risks remain elevated there, the economic growth outlook appears to be quite strong, with interest rates set to continue falling in 2024 from their recent highs of 13.75% this year. Jeff was particularly struck by a vibrant and innovative fintech environment, with companies such as Nubank, XP and Pagseguro all likely to benefit from stronger growth and continued share gains from Brazil's banks.

The agricultural sector has been another success story, with a strong increase in corn production and exports over the last three years as new transport infrastructure has unlocked agricultural potential in the West of the country. Brazil has recently overtaken the US to become the largest exporter of corn.

Like Brazil, political risks in Mexico need to be carefully considered, however it is likely to be a significant beneficiary of several powerful cyclical and structural tailwinds including so-called 'near-shoring' of US supply chains; an emerging middle class of young and aspirational consumers; and lower interest rates. This makes Mexico potentially one of the best growth stories in emerging markets. For example, according to the World Bank, only 37% of Mexicans over the age of 15 years have a bank account (versus 80% in India). This seems likely to increase significantly over the years to come. Highlights from the visit included meetings with Walmex and Banorte, both businesses likely to benefit from the strong growth outlook.

In addition to Latin America, Jeff also travelled to Boston to attend Barclays' Consumer Staples conference, where he met with companies including L'Oreal, Colgate, Unilever, Procter & Gamble, Coca-Cola, Mondelez, Danone, Carlsberg, Nestle, Diageo, Femsa and Estee Lauder. There was high anxiety around the outlook for a recovery to volume growth in many consumer categories as inflationary tailwinds fade, particularly in the U.S. Other key topics included the outlook for China, where the post-covid recovery has been disappointing, and the potential impacts of obesity drugs on alcohol, snack and soft drink consumption.

The key conclusion from his trip was increased conviction in some of the existing Global Equity Fund positions like MercadoLibre, L'Oreal, Pepsi and Procter & Gamble. He will continue to research a number of other prospective companies over the next few months with a view to potentially adding them to our 'best research ideas' list.

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