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May 2022

MONTHLY AGENDA - HEALTH CHECK - AUSTRALIAN EQUITIES

Transition to late cycle

At the time of our most recent Australian equities model portfolio review in August 2021, we noted that we had quickly transitioned from an early to a mid cycle business cycle environment. With the initial phase of the economic recovery (supported by the rollout of vaccines and the twin supports of extraordinary monetary and fiscal stimulus) from the COVID shock passing, we were transitioning to a period from where most sectors and individual stocks were lifted by the rebound in activity to one whereby greater dispersion would become evident in different parts of the market. Consequently, this would call for a move from directional market trades to a greater emphasis on active management given the expectation that not all companies would flourish in this phase.

While we held this expectation that we would begin to see an elevated level of sector dispersion over the course of 2022, year to date the moves in markets that we have witnessed have been more extreme than typical, though consistent with a period of continuing to progress towards later cycle, where macro events and risks have taken on a much greater importance for investors.

The year has been notable for three significant macroeconomic developments – a persistently high inflationary environment which has triggered a considerable repricing of monetary policy tightening; the Russian invasion of Ukraine in February, which added to inflation risks and the tightness of a number of commodity markets; and lastly, increasing concerns around economic growth slowing into the second half, exacerbated by China's rolling lockdowns as it perseveres with a 'COVID-zero' policy

The conclusion that we can thus make is that we have now entered late cycle and can expect economic and corporate profits growth to slow from here, which has been reflected in our recent tactical asset allocation trade to move to an overweight duration bond position.

Table 1: Recap of the business cycle and sector performance

	Early Cycle	Mid-Cycle	Late Cycle	Recession
Financials	✓			
Real Estate	✓✓			××
Cons Disc	✓✓	×	××	
Inf Tech	✓	✓	××	××
Industrials	✓✓			××
Materials	✓	××	✓✓	
Cons Staples			✓✓	✓✓
Health Care	××		✓✓	✓✓
Energy	××		✓✓	
Comm Services		✓		×
Utilities	××	×	✓	✓✓

Early Cycle: There is a clear divide between the winners and losers. Directional tactical asset allocation tends to perform well. The more cyclically sensitive sectors such as consumer discretionary, financials, materials, industrials and real estate tend to perform best. Defensive sectors such as health care, energy and utilities tend to perform worst.

Mid-Cycle: The divide between the winners and losers is less clear so fewer tactical asset allocation opportunities. The focus should be on making slight portfolio allocation changes to protect the downside and quality manager selection within active funds.

Late Cycle and Recession: Directionality returns as does opportunities to add value from tactical asset allocation. Defensive and inflation-protected sectors tend to do better.

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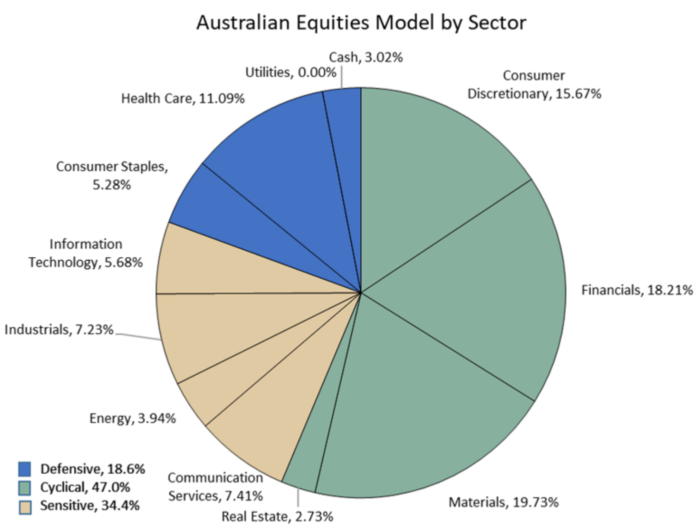
Australian equities sector exposures

Looking at the composition of the Australian equity market, it is clear as to why it has performed much better than most international markets through the first months of 2022, with the ASX 200 outperforming global equities by ~8%. The two largest sectors of the Australian market are financials and materials. Financials have been among the most leveraged to a rising rate environment, as a steepening yield curve leads to margin expansion; however, this effect is dissipating as the yield curve flattens in response to slowing growth. Meanwhile, materials have been buoyed by the strength in commodity prices. This tilt became more pronounced in January as the index's weighting to BHP rose by around 5% after the unification of the company's shares upon the collapse of its dual listing structure.

Equally important has been the significant negative valuation impact on the higher growth sectors of the market (particularly IT) as nominal and real rates have normalised. The Australian market has a lower allocation to these sectors than many international markets, which again has aided in relative performance through 2022. The following chart illustrates the composition of our model equities portfolio by sector.

Chart 1: Australian equities health check



Source: Escala Partners

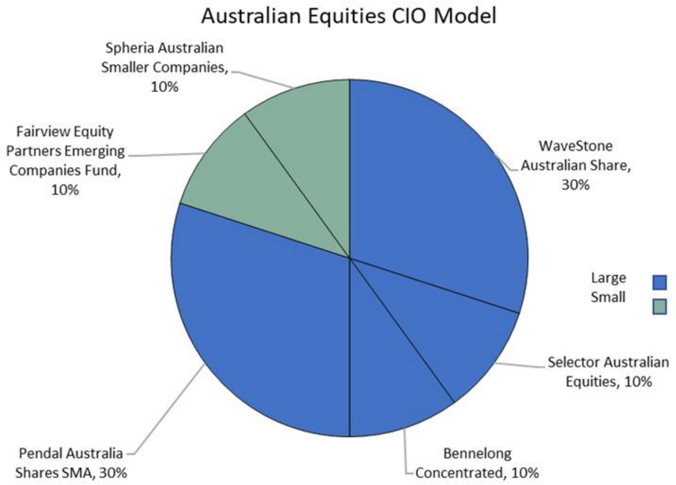
Current model

In January, we made a number of changes to our model Australian equity portfolio in order to adapt to this changing environment. The key changes we implemented were to:

(i) reduce the exposure to more growth-orientated managers who were more exposed to valuation risk as bond yields rose; and
(ii) add to large cap managers that have greater flexibility around style or exposed to sectors more defensive in nature

While we do not have any value-specific large cap managers that would have fully capitalised on these market conditions, the more balanced portfolios of Pendal and WaveStone would have captured some of these themes. Our more growth-orientated managers have a lower capacity to make wholesale changes to their portfolios, however, the focus has generally been one of gravitating towards companies that have pricing power, thus reducing the earnings risk in this period of higher inflation.

Chart 2: Australian equities CIO model and managed funds

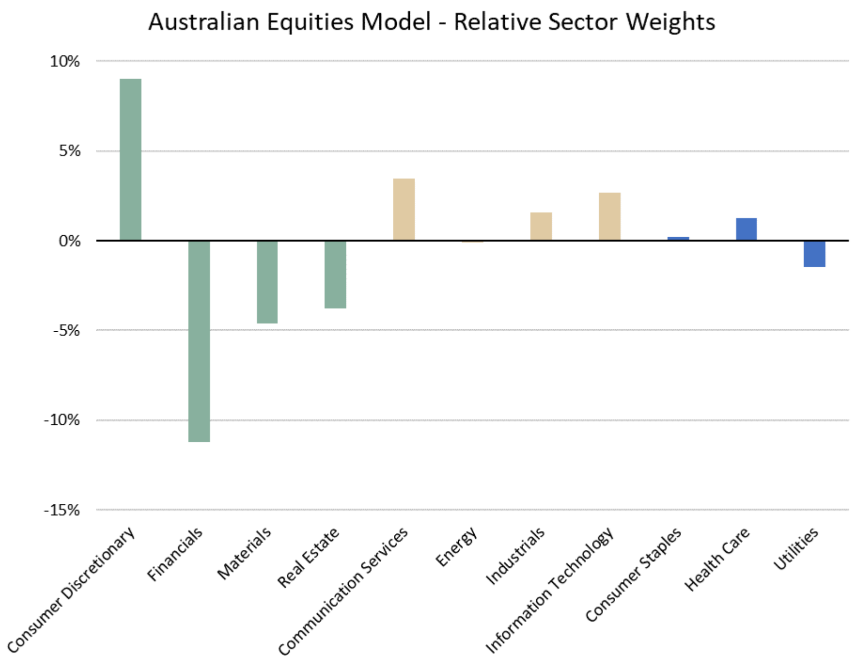


Source: Escala Partners

Australian equities health check

In the table below, we again present the sectors of the market, split into cyclicals (green), economic sensitive (beige) and defensive (blue) in terms of the relative weight compared to the benchmark ASX 200.

Chart 3: Relative positioning



Source: Bloomberg, Escala Partners

In a late cycle environment, the sectors that perform best include materials and energy, while defensive sectors consumer staples and health care also do relatively well.

Our model is underweight the materials sector and neutral energy. The materials sector was key in underpinning the initial recovery out of the COVID crisis period, as is typical in the early phases of an economic recovery. While earnings momentum weakened into the second half of 2021 as more developed countries took the baton from China in driving the global recovery, the sector has returned to favour again through the first part of 2022 as the most important in driving the relative outperformance of the Australian equity market this year.

The economic reopening theme has continued to push commodity prices higher as a consequence of elevated demand and tight supply (the latter a consequence of a period of several years of limited capital investment in new supply by the industry). However, the more significant catalyst has been the Russian invasion of Ukraine, which has placed further pressure on tight commodity markets.

While our model portfolio has not fully realised this commodity price tailwind given its aggregate underweight position to materials, we responded to the development by implementing a tactical asset allocation relative trade of an overweight position in resources (implemented via ETFs) and underweight to European equities. The trade allowed a quick response to this key geopolitical development, but equally allows the trade to be closed if our investment thesis is invalidated for any reason. At this point in time, the most likely reason that would trigger the trade to be closed out is further evidence of increased risks around a sharper economic slowdown than anticipated into the second half of 2022, whether it be in response to much tighter monetary policy and/or weaker growth from China as it stoically maintains its 'COVID-zero' policy.

Presently, the portfolio has a modest overweight to health care and consumer staples. The health care sector is a key sector of the Australian market and most of the larger companies are among the global market leaders in their fields. Many of the key stocks did suffer varying degrees of interruption to their business through the COVID crisis and thus face improving conditions as demand normalises once again over the course of 2022.

In late cycle, the two sectors which typically do poorly are consumer discretionary and information technology.

However, consumer discretionary has remained the largest overweight position in the model, which was the case at the time of our last review. Presently, of the six managers in our model portfolio, five are overweight the consumer discretionary sector, and so this high weighting will continue to be monitored given these companies are more likely to struggle as the cycle matures. A feature of this cycle has been the contrasting environments faced by the so-called 'COVID beneficiaries' (i.e. those that saw an increase in demand through the lockdown periods, such as retailers with a strong eCommerce model) and companies more services-orientated that suffered disproportionally though this period. This latter group is expected to experience a significant rebound in pent up demand as the reopening continues, with reduced downside risk compared to the COVID beneficiaries. Pleasingly, our model has several of these as large positions across gaming (Aristocrat Leisure), education (IDP Education) and travel (Flight Centre and Corporate Travel).

The model has also retained a slight overweight to information technology, though this has been reduced with our recent portfolio changes. Assessing the large information technology exposures of Xero, Technology One and Iress, each have a high proportion of recurring software subscription-based revenue streams, providing some degree of downside risk in late cycle.

As we have witnessed through the first few months of 2022, the greater risk around companies that are either marginally profitable or yet to be cashflow breakeven is one of valuation (many of which are found in sectors such as IT), particularly if they are not self-funding in nature and have a near-term requirement for additional capital funding. Looking at our model portfolio, there is currently just over a 2% exposure to companies not expected to be profitable in the next 12 months, hence this risk is not material. Nonetheless, future changes to our portfolio are likely to reflect our preference for a lower allocation to the sector.

In late cycle, other sectors of the market are less likely to be influenced by the macro environment.

Financials is a key sector of the ASX 200 and comprise 18% of the model portfolio, though the sector is the largest underweight relative to the benchmark ASX 200. The sector typically has a low representation among more growth-orientated managers such as Selector and Bennelong, along with a lower allocation among small cap funds.

As noted, financials are a key cyclical sector that typically benefits from a steepening yield curve, a factor which will become more of a headwind in late cycle as the yield curve flattens. In this monetary policy hiking cycle in particular, there are risks around the pace and number of hikes (short and sharp) being made with a prevailing high level of household debt. Hence, this poses risks around a slowdown in the housing market, reduced economic growth and rising bad debts. Therefore, a somewhat more cautious approach is reflected in our managers' exposures

Conclusion

The structure of the Australian market has been key in leading to strong outperformance of global markets so far in 2022. However, we are cognisant of the risks as the cycle matures, and this will be reflected in both our asset allocation and within our model Australian equities portfolio as the environment and outlook evolves.

Top holdings

Given the relatively concentrated nature of the Australian market among the largest constituents, it is of no surprise that our largest three portfolio holdings have remained since the last review, albeit in a different order.

BHP Billiton is among the largest and most diversified companies within the global mining industry. Its suite of long-life, low-cost mines ensures robust returns and margins relative to its peers through the commodity pricing cycle. In more recent years the company has pulled back from a more profligate capex spending program that contributed to the prior downturn in commodity markets and instead focused on balance sheet repair, optimising its portfolio via the sale of non-core assets and maximising its returns to shareholders. A further rally in commodity prices in 2022 has provided a boost to its short term earnings profile, though some mean reversion is still expected over 2023/24 as markets adjust to a maturing global growth cycle. The company's ESG credentials have also been enhanced this year with the recent approval to divest its oil and gas assets to Woodside, accelerating its strategy to reduce its exposure to fossil fuels. While BHP is the largest holding in our model portfolio, the stock is actually underweight relative to its ASX 200 benchmark weighting of 11%.

CSL remains a key holding across our four large cap funds. The company has been a core long-term investment for many domestic large cap managers thanks to its enviable track record of capital allocation, strong management, high returns on its investment and operational performance. The stock has underperformed though much of the COVID crisis, with its business disrupted through reduced traffic at its plasma collection centres in the US, though this outlook is improving as economies reopen. Additionally, its medium-term earnings profile is enhanced by the synergies expected to be realised from its recent acquisition of Vifor Pharma.

Commonwealth Bank is the largest of the four major banks and is typically seen as the highest quality of the group. The four major banks have all followed a similar strategy over the last several years of exiting the more peripheral parts of their businesses, such as wealth management, which was in part borne out of their shortcomings that were revealed in the banking royal commission. As with the other majors, the primary impact of COVID on Commonwealth Bank was a sharp rise in bad debt provisions – which are now being written back as the economy recovers on the back of fiscal and monetary support. Commonwealth Bank has historically traded at a healthy premium to its major peers (which is presently the case), which is attributed to its market leading return on equity and retail franchise. Reflecting this valuation differential, the stock is actually the largest underweight of the four major banks in the model (relative to the ASX 200).

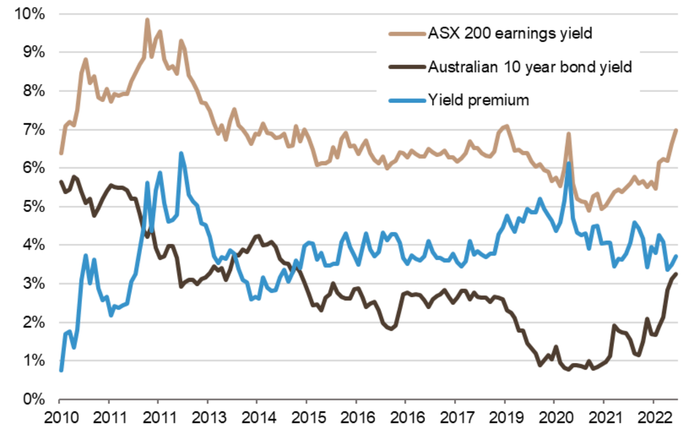
Table 2: Top 10 positions

Stock	% Holding	Sector
BHP Group	7.72%	Materials
CSL	6.79%	Health Care
Commonwealth Bank	3.59%	Financials
Aristocrat Leisure	3.19%	Discretionary
National Aust Bank	3.13%	Financials
Santos	2.86%	Energy
James Hardie	2.60%	Materials
Macquarie	2.31%	Financials
ANZ Banking Group	2.24%	Financials
Qantas	1.95%	Industrials

Table 3: Top holding in each sector

Sector	Top Holding	Weight
Materials	BHP Group	7.72%
Financials	Commonwealth Bank	3.59%
Consumer Discretionary	Aristocrat Leisure	3.19%
Health Care	CSL	6.79%
Communication Services	Telstra	1.94%
Industrials	Qantas	1.95%
Information Technology	Xero	1.55%
Consumer Staples	Woolworths	1.08%
Energy	Santos	2.86%
Real Estate	Lifestyle Communities	0.55%

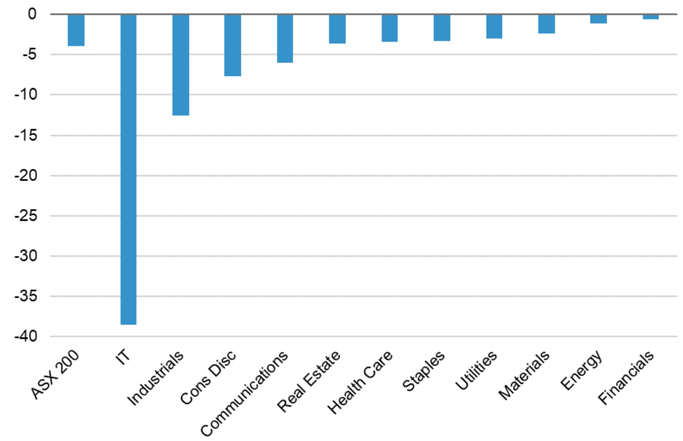
Chart 4: Forward equity risk premium stable



Source: Bloomberg

Does the Australian equity market look cheap? This is not necessarily the conclusion you would reach if looking at the premium that investors are currently receiving for investing in domestic equities over government bonds. The yield premium has averaged around 4% since 2010 and the chart illustrates that, at the current premium, the market is close to fair value. The PE de-rate in the market through this year has therefore matched what one would expect given the sharp rise in bond yields we have witnessed.

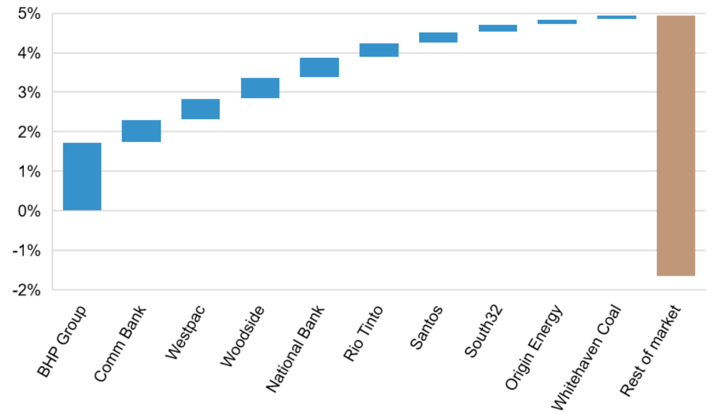
Chart 5: High growth sectors continue to bear the greatest valuation adjustment (Change in forward PE ratio in 2022)



Source: Bloomberg

With earnings holding up relatively well so far in 2022, weaker equity returns have been explained almost entirely by a decline in valuations. The decline in valuations continues to be far from uniform across the various sectors of the market, with high growth sectors affected disproportionally as yields have risen. The domestic information technology sector has suffered much more than most, with the forward PE dropping almost 40 points since the beginning of the year.

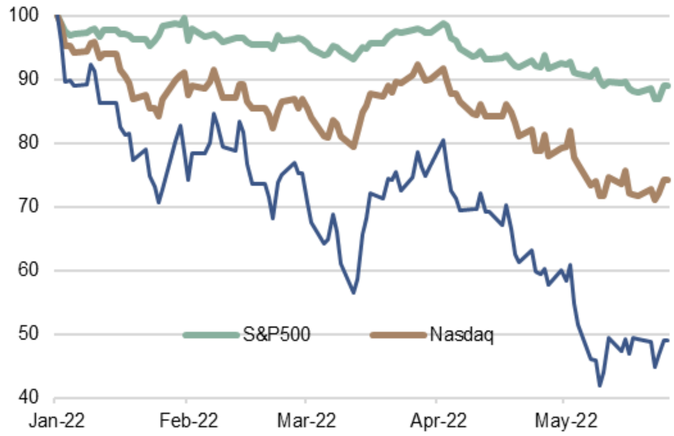
Chart 6: Market driven by resources and banks: attribution in 2022



Source: Bloomberg

Which stocks and sectors have been driving the ASX 200 so far in 2022? The top 10 contributors to the index's performance (which have added nearly 5% overall to the market) tell a story, which include three of the four major banks and then a mix of resources stocks. Managers with little exposure to these sectors of the market would have thus struggled for performance - the rest of the market combined has lost more than 6%, leaving the benchmark slightly lower year to date.

Chart 7: Is profitless tech at the bottom?



Source: Bloomberg

2022 so far has seen the US stock market mete out immediate and cruel punishment to companies that don't yet earn a profit. The sell-off in the profit-less tech sector that began in earnest at the start of the year looks to be at least taking a breather with the index moving sideways for the past 3 weeks. The S&P 500 and Nasdaq 100 also seem to have stabilised for now after falling 11% and 26% respectively since the beginning of 2022. Even Apple is down 19% year-to-date despite it being flush with cash. Old-school tech, on the other hand, has been spared. IBM is up 2% for the year. Fellow 'old-school' tech giant Hewlett-Packard - now split into HP and Hewlett Packard Enterprise - are also trading well, little changed on the year.

Chart 8: S&P500 cyclicals v defensives

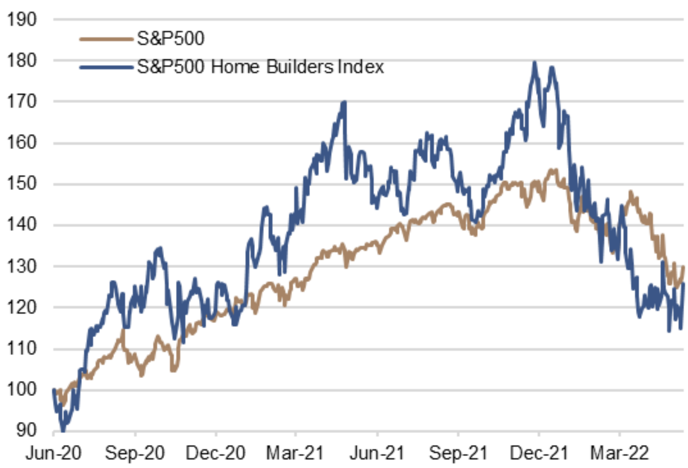
Source: Bloomberg

Discretionary (a cyclical sector) is the worst-performing S&P 500 sector ytd, while staples (defensive) is little changed, the best performer after energy.

Discretionary is heavily tilted toward Amazon.com and Tesla, so in some way the sector is more a reflection of big tech than the consumer. And big tech has been hit by rising yields and fears of tightening monetary policy and a recession. But discretionary declines have been broad-based: only 10% of the sector is trading above their 200-DMA.

Staples defensive status has given them some support. Companies who have managed to navigate rising price pressures, especially by raising prices, have been rewarded.

Chart 9: Builders sell off ahead of broader market



Source: Bloomberg

Homebuilder shares are declining after sales of new homes plunged in April, falling well short of all estimates, while months' supply rose as well. Nevertheless, home prices advanced 3.6% in the month following March's 1.8% climb, bringing the increase year-over-year to ~20%.

It remains to be seen when prices might begin to recede. In recent days, Redfin said homebuyer competition had fallen for a second month in April, hitting the lowest in over a year.

Chart 10: The number of rate hikes priced for 2022

Source: Bloomberg

Most US Federal Reserve officials agreed at their meeting in May that the central bank needed to tighten in half-point steps over the next couple of meetings, continuing an aggressive set of moves that would leave policy makers with flexibility to shift gears later if needed. The Fed updated their forecast for inflation as measured by the PCE of 4.3% in 2022 but they lowered their forecast to 2.5% in 2023 and 2.1% in 2024. If their forecast is accurate, it would imply the next expected three half-point rate hikes could be the end of the current tightening cycle and set the stage for a major risk rally into second half of 2022. The market has reduced the number of quarter point rates for this year to 7.

Chart 11: US 30-year fixed mortgage rate (%)

Source: Bloomberg

Thirty-year mortgage rates fell for a second week in the US. Rates are now 5.29%, the lowest in 4-weeks. That's down from the peak of 5.57% on May 12, the highest since 2009 and compares with 3.3% at the start of the year. Rises in lending rates has caused home buyers to back away and mortgage origination to slow recently. And April data showed housing starts, new and existing home sales, as well as pending home sales missed estimates while previous-month data was revised lower.

Chart 12: Market expectation of inflation fall (%)

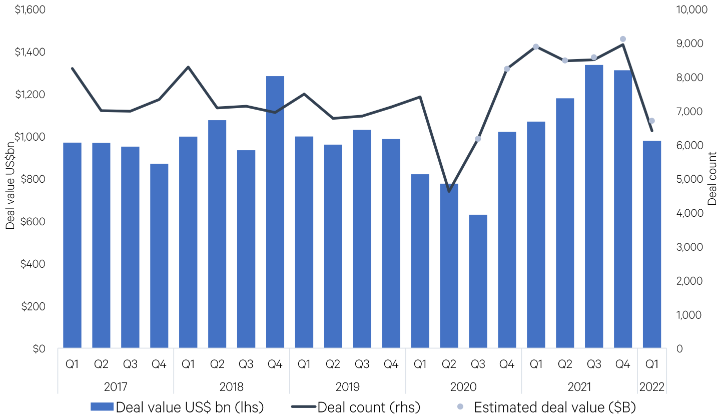
Source: Bloomberg

Inflation expectations in the US bond market are subsiding despite the recent resurgence in the commodity complex. That aligns well with the perception that the risk of recession is increasing. At some point supply-shock-driven inflation is likely to bring about its own demise via demand destruction, and bond investors look to be signalling we are getting close to a turning point for broad price gains even if wheat and crude stay elevated.

Asset Class View

Alternatives

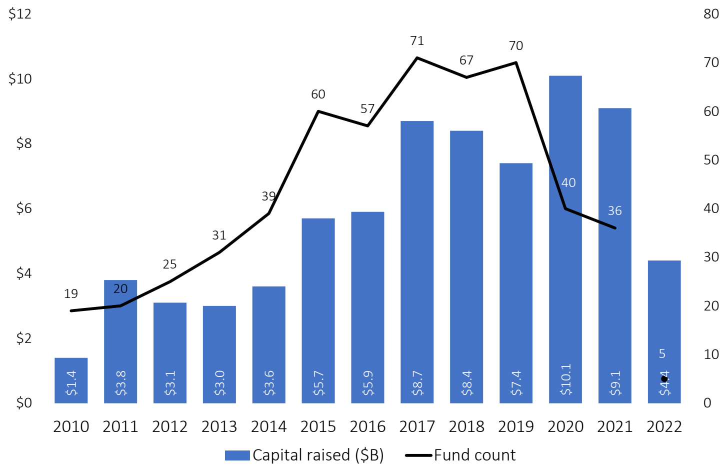
Chart 13: Global M&A Activity



Source: Pitchbook

Global M&A activity fell in Q1, 2022 compared to the activity seen in the back half of 2021 but were healthy compared to the past five years. Tech was a dominant force during the quarter, continuing a decade-long trend. With the prolonged inflationary pressures, natural resources prices have steadily risen and show no signs of falling. A more lucrative pricing environment has begun to attract capital to the space. While a significant amount of capital has flown to traditional energy spaces, the renewable energy space continues to grow as well. Investment into the green energy sector also benefits from a plethora of natural resources opportunities.

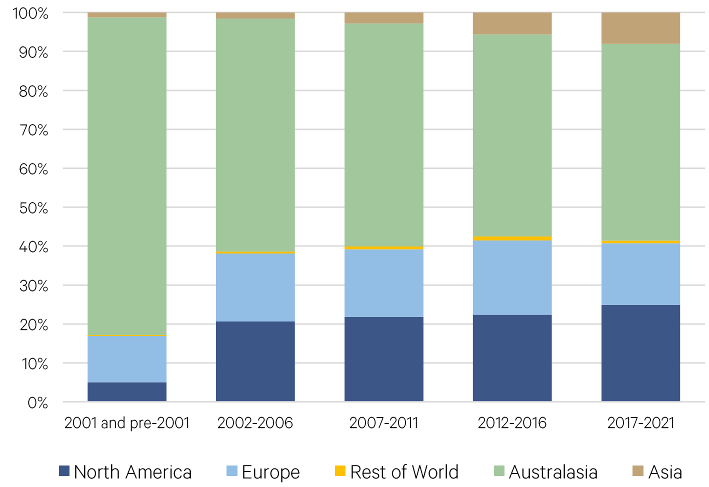
Chart 14: Australian-focused private capital fundraising, 2010-2022 YTD



Source: Preqin and Australian Investment Council

Australian-focused capital assets under management has continued to advance over the past few years attributable to an increase in the value of existing investments and the strong fund-raising environment. While fundraising slowed marginally in 2021 in comparison to 2020, it's still higher than the years prior and the second highest since 2010. Aggregate capital raised fell by 10% year-on-year, as a total of 36 private capital funds achieved final close in 2021, raising $9.1bn. The figure was still 23% more than 2019's $7.4bn.

Chart 15: Foreign funding in Australian private capital funds



Source: Preqin and Australian Investment Council

Foreign investors have grown more active in Australia over the years. Two decades ago they accounted for just 18% of investors in Australian private capital funds; since 2017 they have accounted for just under half at 49%. The combination of a stable political environment, a strong economy, robust governance, and dynamic market conditions makes Australia an attractive investment landscape. North American investors are the largest contingent of foreign investors in Australia, accounting for 48% of the funds that have received foreign funding in the past five years. Private equity is the most attractive asset class to foreign investors, making up almost half of known commitments to Australian private capital funds.

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Contact

Chief Investment Office

Tracey McNaughton, CFA
Chief Investment Officer

David Bruty, CFA
Investment Analyst

Stephen Dickinson, CA
Investment Analyst

Darragh Kennelly, CFA
Investment Analyst

Charlotte North
CIO Investment Assistant

Escala Partners Pty Ltd

Melbourne:
Level 19, 90 Collins Street
Melbourne Victoria 3000
Telephone: 03 8651 2600

Sydney:
Level 25, Governor Macquarie Tower
1 Farrer Place
Sydney NSW 2000
Telephone: 02 9102 2600

Perth:
2/328 Stirling Highway,
Claremont WA 6010
Telephone: 08 6282 2600

information@escalapartners.com.au
www.escalapartners.com.au

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