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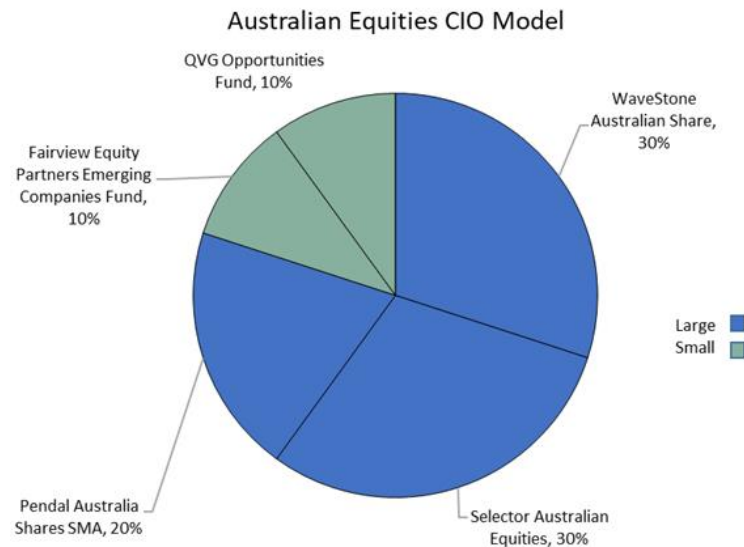
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*August 2021*

# MONTHLY AGENDA - HEALTH CHECK - AUSTRALIAN EQUITIES

A transition into mid cycle business cycle settings can result in sharp shifts in the drivers of the Australian equity market. With the market tilted towards those sectors that are more cyclical in nature like financials and resources, sector allocation and stock selection become more critical drivers of performance. This month we assess how our Australian equities model portfolio is placed in these rapidly changing conditions.

**Chart 1: Australian equities CIO model of managed funds**



Source: Escala Partners

## Transition from directional to active management

Late last year we placed a directional trade on the Australian equities market. The trade was implemented with a broad market, passive ETF given our view that the large expansionary fiscal stimulus implemented in response to the domestic COVID situation would find its way across most sectors of the market. We closed the position with a 14% profit in March 2021 as the end of JobKeeper payments neared along with a decline in market breadth.

This trade was consistent with our directional approach which works well in early phase of a cycle. However, as we have noted over the last several months, we have now quickly transitioned into mid cycle, with the economy rebounding sharply from the induced coma triggered by the COVID crisis.

There are several signs domestically that suggest we have passed from early to mid cycle. The economy has surpassed its pre-pandemic level recorded in December 2019. The employment market has recovered the significant job losses experienced in the initial months of the pandemic. The Australian dollar has fallen from almost US80c to be closer to US70c today. In a similar fashion to that in the US, our yield curve has flattened again, with the yield on 10-year government bonds falling. The Reserve Bank of Australia has communicated that a tapering of its asset purchases will begin in September and has signalled that fiscal policy is the “more appropriate instrument in the current circumstances”. Finally, economic data points from China have weakened in the last six months and have contributed to commodity prices pulling back sharply.

All of this combined with the short-term uncertainty as a consequence of further lockdowns has provided a more challenging environment for our Australian equity managers. Much greater dispersion in sector and individual stock performance is what investors should expect in this environment. Greater active management is thus preferred in this phase of the cycle.



**Table 1: Recap of the business cycle and sector performance**

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

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.

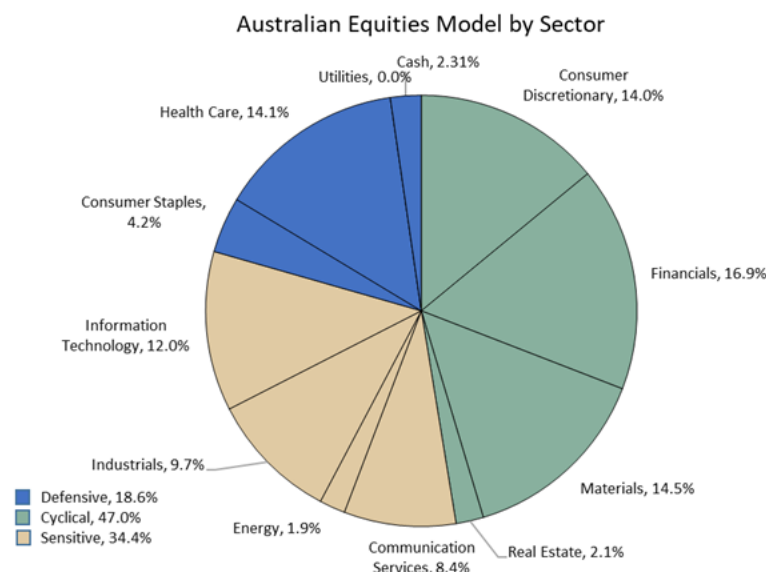
Mid-Cycle: The divide between the winners and losers is less clear so fewer tactical asset allocation opportunities. The focus should be on making slight portfolio allocation changes to protect the downside and quality manager selection within active funds.

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.

## Australian equities health check

The chart below illustrates the blended sector weights of our Australian equities model portfolio, while grouping each of these into the three broad baskets of defensives, cyclicals and economic sensitive.

**Chart 2: Australian equities health check**



Source: Escala Partners

One key takeaway from our model portfolio is that, save for a few outliers, the portfolio has a fairly balanced exposure to the different sectors of the market.

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On a positive note, our portfolio is well represented by the two key sectors of the market that are expected to perform well as we progress through mid-cycle, being information technology and communication services.

The portfolio's allocation to information technology is primarily driven by the allocation to Selector, which has had a longstanding allocation to the sector. The portfolio has several holdings in the sector, demonstrating a good level of diversification. These companies typically have a long pathway of growth, are less dependent on the 'economy re-opening' theme and have exposure to overseas markets, thus standing to benefit from the recent weakness in the Australian dollar.

Looking at communication services reveals that the sector is somewhat broader than pure telecommunications companies such as Telstra. The sector also includes the key online classifieds businesses of REA, Seek and Carsales.com, all of which are represented in the blended portfolio. While these businesses do have an element of cyclicity in them, the broader structural theme of print-to-online underpins their profile.

Additionally, these two sectors are also favoured by one of our small cap funds in QVG.

Consumer discretionary is a key sector of the market that does warrant some monitoring going forward. Consumer discretionary companies are typically the beneficiaries at the early stage of a business cycle as consumer sentiment rises and household spending picks up. This has certainly been true of the current recovery out of the COVID downturn, although crucially there has been a higher disparity between the winners and losers in the last 18 months. Companies that have been able to continue to operate have experienced a surge in demand – think Wesfarmers (primarily Bunnings), JB Hi-Fi, Harvey Norman and Domino's.

Other consumer discretionary companies have faced more onerous restrictions placed on their operations, such as travel websites and casinos. Picking the winners as spending transitions from goods to services is likely to become more critical for managers as we emerge from the periodic lockdowns across the country. Aristocrat Leisure is currently a popular pick among our large cap managers and pleasingly is more closely linked to the opening of economies such as the US.

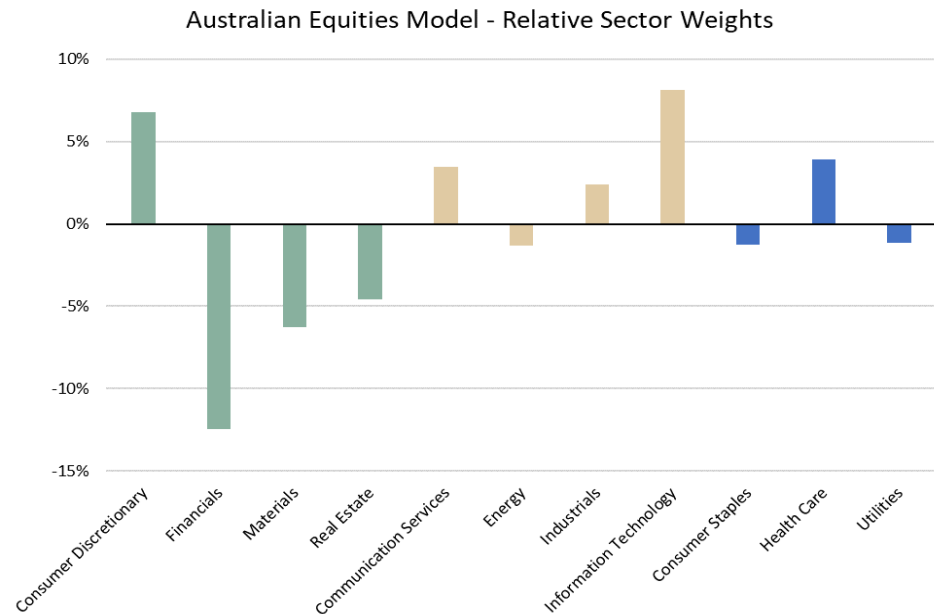
At a top-down level, our model has a reasonably high exposure to the more cyclical sectors of the market (47%) compared with economic sensitive (32%) and defensives (18%). While these sectors stand to perform well early cycle (and this has certainly been the case over the last several months), the conditions become less favourable as the cycle matures.

This is going to be true of the majority of Australian equity portfolios due to the composition of the domestic market where financials and materials account for half of the benchmark ASX 200 Index. Together with consumer discretionary and real estate, they combine almost two thirds of the benchmark.



Another way of analysing our model portfolio is to assess the blended weightings against the benchmark, as illustrated in the chart below.

**Chart 3: Relative positioning**



Source: Bloomberg, Escala Partners

Three of these four cyclical sectors are underweight in the portfolio relative to the benchmark, including financials (-12%) and materials (-6%), which is a positive as we transition to mid cycle. The major banks are a key component of the financials index and have clearly been a beneficiary of fiscal and monetary stimulus over the last 12 months. While recent profit growth numbers look impressive, this has been primarily driven by the writeback of bad debt provisions that were raised at the height of the COVID crisis, with underlying growth far less impressive and share prices supported more by the prospect of capital management.

Likewise, the materials sector has been critical in underpinning the earnings and returns of the ASX 200 during 2021. However, there is good reason to believe that this momentum will fade into the second half of the year, which is consistent with the expected performance in mid cycle. Commodity demand soared through the synchronised global recovery, though a concern for us that has arisen in recent months has been the deterioration in economic indicators in China, the country 'first in' and hence 'first out' of the disruption from COVID. Furthermore, in recent months China has had some success in introducing measures to curb commodity speculation, with most key commodity prices falling from their peaks in the last quarter. Iron ore has also belatedly peeled back in recent weeks, indicating that the healthy profits and cashflows enjoyed by the sector are unlikely to be sustainable. Our blended portfolio is well placed to manage such a correction, being underweight the sector, particularly through Selector, WaveStone and QVG.



## Top holdings



Relative to many developed equity markets, the ASX 200 is concentrated among its largest constituents. Consequently, it should not be surprising to discover that large cap portfolios will often have a somewhat high level of crossover in their top portfolio holdings.

This also proves to be the case for our blended portfolio, with the three largest holdings being among the largest in the market.

CSL is a key holding across our three large cap funds, though in aggregate, our managers are slightly underweight the stock compared to benchmark. 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 through 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.



BHP Group has arguably the most diversified portfolio of resources assets of all listed miners on the ASX. 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 retreated from a 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. Over the last 12 months, BHP has been buoyed by strong commodity demand and tight supply across most of its key markets and trades on a high dividend yield which is at risk from falling commodity prices. The company has also been the favoured option for Australian equity managers with a higher ESG filter after Rio Tinto's admission of the destruction of sacred indigenous sites in the Pilbara and this could be enhanced further by its announcement this month of the disposal of its petroleum portfolio to Woodside.



**Commonwealth**Bank

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 five 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 Financial Services 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 attributed to its market leading return on equity and retail franchise. Perhaps in recognition of its relatively stretched valuation (price/book ratio of 2.3x and price/earnings ratio of 19x), in our blended portfolio the stock is 5% underweight relative to the ASX 200.





**Table 2: Top 10 positions**

Stock	% Holding	Sector	CIO Model Funds
CSL	5.27%	Health Care	Selector, Pental, WaveStone
BHP Group	5.19%	Materials	Pental, WaveStone
Commonwealth Bank	3.55%	Financials	Pental, WaveStone
Aristocrat Leisure	3.15%	Discretionary	Pental, WaveStone
James Hardie	3.13%	Materials	Selector, Pental, WaveStone
ANZ Banking Group	2.73%	Financials	Selector, Pental
Resmed	2.47%	Health Care	Pental, WaveStone
Cochlear	2.07%	Health Care	Selector
Domino's	1.89%	Discretionary	Selector, WaveStone
Carsales.com	1.75%	Communications	Pental

Source: Escala Partners

**Table 3: Top holding in each sector**

Sector	Top Holding	Weight	CIO Model Funds
Consumer Discretionary	Aristocrat Leisure	3.15%	Selector, Pental, WaveStone
Financials	Commonwealth Bank	3.55%	Pental, WaveStone
Materials	BHP Group	5.19%	Pental, WaveStone
Real Estate	LifeStyle Communities	0.25%	WaveStone, QVG, Fairview
Communication Services	Carsales.com	1.75%	Selector
Industrials	Reece	1.49%	Selector
Information Technology	Xero	1.23%	Pental, WaveStone
Consumer Defensives	Woolworths	1.12%	WaveStone
Health Care	CSL	5.27%	Selector, Pental, WaveStone
Energy	Santos	1.11%	Pental, WaveStone

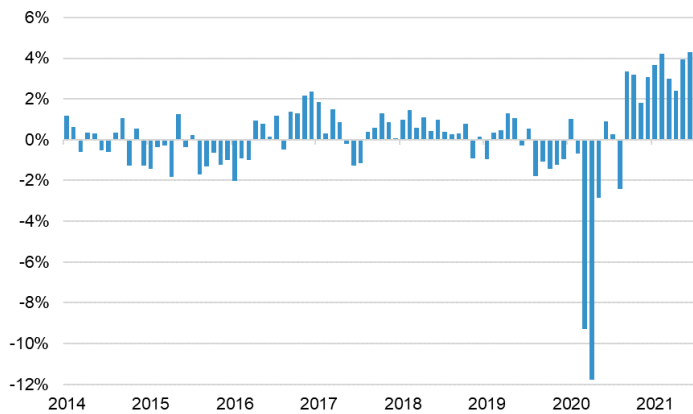
Source: Escala Partners



## Asset Class View

## Australian Equities

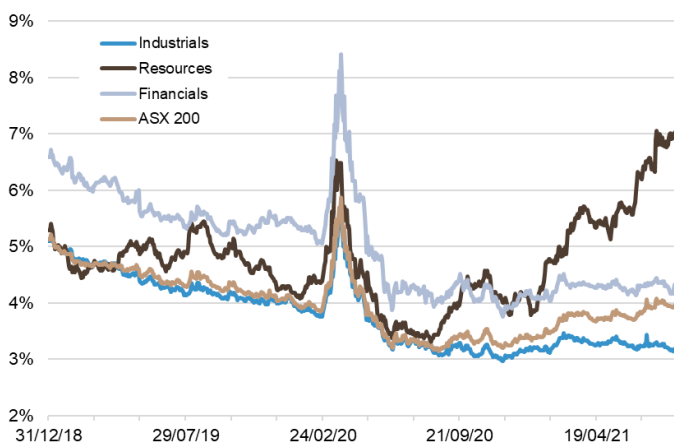
**Chart 4: Expectations high in the lead into reporting season - monthly earnings upgrades**



Source: Bloomberg

The ASX 200 has maintained a trend of strong earnings upgrades since late last year at an average of more than 3% per month. While recent upgrades have been led by the resources sector, earnings upgrades have still been broad-based in nature and thus expectations were high for August's full year reporting season.

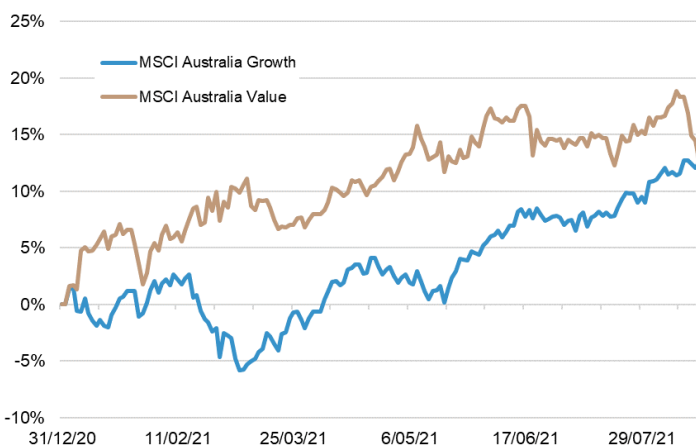
**Chart 5: Resources dividends supporting the market's dividend yield**



Source: Bloomberg

At the height of the COVID crisis, the forward dividend yield on the ASX 200 fell to a low of 3.2%. While dividends have risen in the current reporting season, the yield of the market still remains less than 4% due to the strong equity returns over the last 12 months. With yields on industrials and financials stocks remaining below pre-COVID lows, it is the resources sector which is helping to lift the overall dividends of the market as the miners return a high proportion of their profits to shareholders.

**Chart 6: Australian growth catches up with value in 2021**



Source: Bloomberg

Australian value stocks were significant outperformers relative to growth in the early part of 2021 on the back of enthusiasm around the economic recovery and rising commodity prices and bond yields. With the yield curve since flattening, uncertainty arising amid further lockdowns and commodities retreating, the gap between the two indices has closed.





## Asset Class View

## International Equities

**Chart 7: Emerging market equities feel the weight of a stronger US dollar**



Source: Bloomberg

A sense of foreboding is spreading through emerging markets on concern that China's slowing recovery and the fast-spreading Delta virus could crimp global growth. Yet the hardest blow could come from a renewed selloff in U.S. government bonds. This upward pressure on US 2-year bond yields is being driven by the market pricing in higher official interest rates from the US Federal Reserve within the next 2 years.

The yield on the 2-year US government bond tends to put upward pressure on the US dollar.

With so much dollar-denominated debt, a stronger US currency tends to weigh on emerging market equities.

**Chart 8: S&P Cyclical / S&P Defensives**



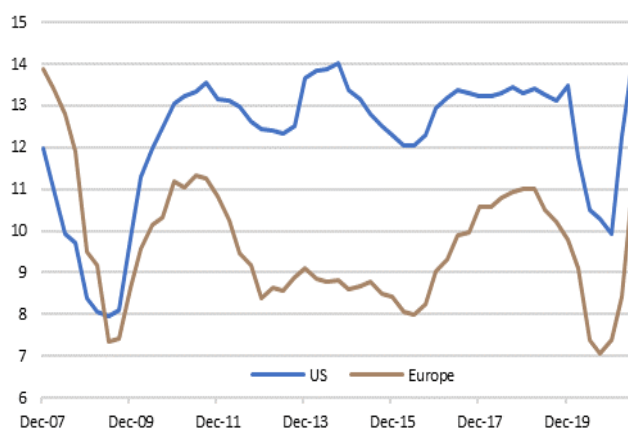
Source: Bloomberg

U.S. stock investors are likely to tilt more defensive as COVID cases rise and economic data weaken.

So far in August, utilities, health care and consumer staples are three of the four best S&P 500 performers, with financials at number one.

There are some sector-specific reasons for the August gains. Utilities have gotten upside from summer power demand and some declines in bond yields over the past few weeks. Health care vaccine stocks have risen on the prospect of a U.S. booster plan. But an underlying thread is rising fears of the delta variant, inflation and peak growth.

**Chart 9: US and European equities operating margins**



Source: Bloomberg

Peak earnings growth doesn't mean profits can't drive stocks higher. A key determinant will be if profit margins hold up, and so far, there are encouraging trends on that front.

Some companies are using price increases and productivity gains to offset rising material costs.

In Europe, the Stoxx 600 operating margin on a quarterly basis has rebounded from pandemic lows to over 11%, the highest since 2011. In the US, margins are at 14.2%, the highest on record.

Plenty of unknowns from COVID and inflation remain, but profit fundamentals remain supportive.

## Asset Class View

## Fixed Income

**Chart 10: Australian dollar falls against the yen**

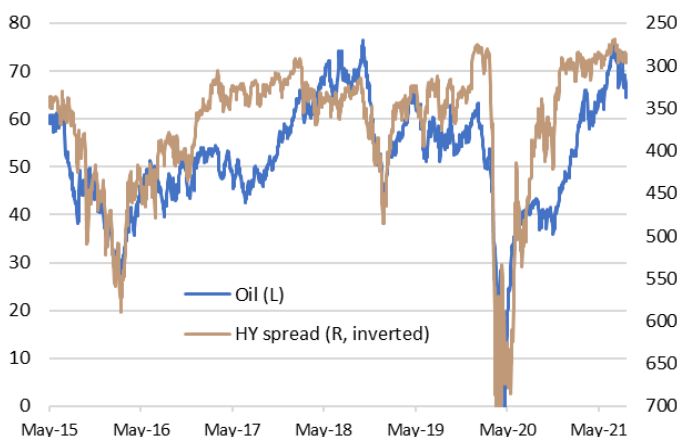


Source: Bloomberg

The currency market is beginning to show signs of growing risk aversion as investors debate a global economic slowdown.

The top-performing G-10 currencies so far this quarter - by a long way - are the yen and the Swiss franc, which are up 1.7% and 1.3% respectively against the US dollar. JPY/AUD climbed out of a year-and-a-half downtrend - a pair which is often used as a gauge of global risk sentiment. Strength in the yen means the currency market has now joined bonds in signalling an aversion to risk. That leaves equities where investor sentiment remains reasonably solid.

**Chart 11: Slower growth weighs on oil which weighs on high yield**



Source: Bloomberg

Crude oil is struggling, with global benchmark Brent at risk of retreating to the lowest close in three months. Prices are taking a twin hit, with demand hurt by the delta variant's spread while OPEC+ keeps on easing supply curbs.

The US central bank meeting minutes showed most participants want to start reducing the pace of asset purchases this year, which isn't a total shock to markets. In any case, a Fed forging ahead with tapering in the face of rising virus, slower growth, isn't exactly a recipe for boosting risk appetite. Oil could go lower which given the number of oil supply companies in the index, will push high yield down (spreads wider).

**Chart 12: Combined balance sheet of the 4 largest central banks (USD tn)**



Source: Bloomberg

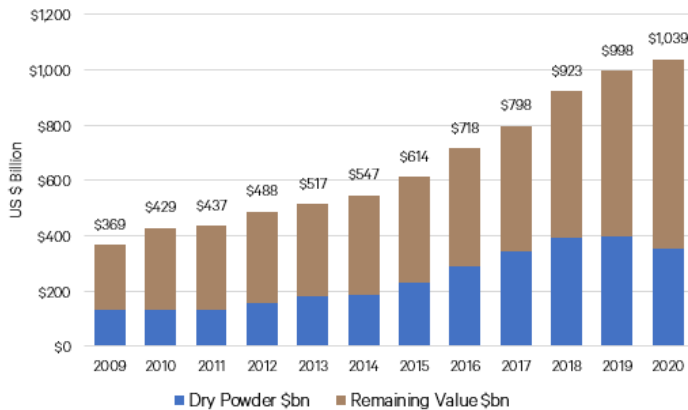
The combined balance sheet of the four largest central banks surged by more than \$10 trillion since the end of February 2020. That is roughly \$1,300 for every man, woman and child that was alive on the planet at the start of that period.

Except that rather than be handed out to the world's population, that \$10 trillion has essentially gone into financial assets. This at a time when the universe of listed public assets is shrinking. Is it any wonder equity markets keep hitting record highs?

## Asset Class View

## Alternatives

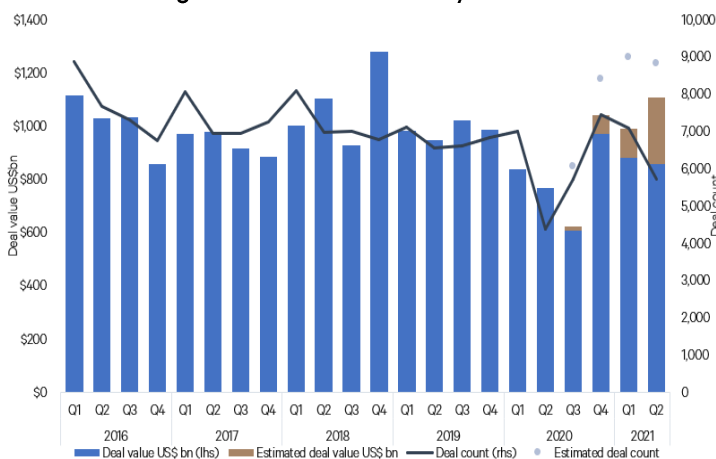
**Chart 13: Private debt market surpasses \$1 trillion**



Source: Pitchbook

The private debt asset class has now surpassed \$1 trillion in AUM and continues to quickly approach the size of the public leveraged loan and HY bond markets in the US. Continually low interest rates, subdued default rates, and a broader pivot toward alternatives continue driving investors into private debt strategies. Though fundraising has posted strong results in recent years, the amount of available capital (dry powder) in private debt funds has fallen. Heavily dependent on other private capital strategies and M&A for deal flow, private lenders and debt investors have seen a range of deployment opportunities in the last year.

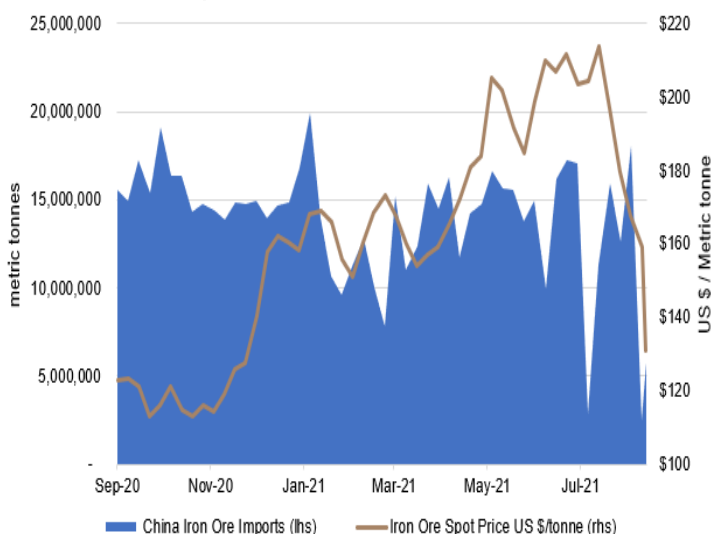
**Chart 14: Strong bounce in M&A activity**



Source: Pitchbook

Global M&A activity saw a strong recovery in H1 2021, both dealmaking count and value are on pace to approximate or surpass record highs. In total, more than 17,000 deals closed with a combined value exceeding \$US2 trillion. A combination of healthy stock market returns and cheap financing encouraged the rush of deals. The bounce back from the pandemic-induced lows in 2020 is continuing to pick up steam, although the recovery has not been evenly felt thus far. Deals are being pursued in the faster-growing sectors such as technology, healthcare, and financial services as well as in some areas impacted by a yearlong lockdown.

**Chart 15: Iron ore price sinks on Chinese demand outlook**



Source: Bloomberg

Iron ore prices have fallen thirty percent in just one month and now trade at their lowest levels in over eight months on expectations of lower output and consumption from the world's largest steel producer. Chinese imports of the key raw material fell to their lowest levels in five years as the government pressures steel mills to reduce production in an aim to tackle pollution levels. Prices could have further to fall yet as Citi estimate prices hitting \$US125 by 2022.

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