Pendal Monthly Commentary

Pendal Australian Shares Portfolio

June 2022

Market commentary

The US Federal Reserve's determination to bring inflation under control is stoking fears of recession. This was exacerbated in June by a CPI print which came in slightly higher than expected and showed inflation broadening across categories.

The Fed hiked rates 75bps in June and indicated that they could do the same again in July. They are now signalling that they could end the year at 3.4%, according to the "dot plot" of expected moves. Three months ago, this figure was 1.9%.

Other central banks are striking a similarly hawkish tone with regard to the pace of rate hikes. The Reserve Bank of Australia hiked 50bps.

This saw sharp falls in equity markets, as investors start to factor in the risk of earnings downgrades. It also saw a rotation away from value and the more cyclical sectors.

Australia underperformed as a result, with the S&P/ASX 300 off -9.1%. The S&P 500 fell -8.4% and the Euro Stoxx -8.8%. However the Australian market has still outperformed over the calendar year to date.

The two largest sectors of the Australian market - which had held up well thus far - were both hit hard. Materials fared worst as commodity prices tumbled and dragged on the miners. Iron ore fell -11.9% and copper -12.6%. BHP (BHP, -7.5%) held up better than most of the other miners, which saw double digit falls. The copper and lithium miners underperformed, having been among the sector better performers previously.

Financials fell as the RBA's rate hike triggered fears of domestic recession and saw some shorting of Australian banks, particularly by international investors. ANZ (ANZ, -12.0%) held up best of the Big Four, while Westpac (WBC, -18.3) fared worst. The insurers held up much better, with QBE (QBE, +1.0%) managing a small advance.

Consumer Staples held up well as investors sought defensive pockets. Woolworths (WOW, +2.7%), Coles (COL, +1.6%) and Endeavour (EDV, +4.3%), the three largest stocks in the sector, all made gains.

Energy also outperformed and held up well despite Brent crude oil falling -6.5%, thermal coal -9.6% and natural gas -23.2%. This was largely due to strength in the newly re-christened Woodside Energy (WDS, +7.0%), the largest stock in the sector. It did well in the wake of the tie up with BHP's oil and gas assets. Other energy producers such as Santos (STO, -9.5%) were softer. The fuel retailers such as Ampol (ALD, +2.6%) and Viva Energy (VEA, +1.8%) did well on the back of recovering volumes and strong refining margins.

Portfolio overview

Australian Shares Portfolio	
Investment strategy	The strategy employs a bottom up, fundamental approach to build a diversified portfolio of Australian shares where the majority of active risk and outperformance is driven by stock selection.
Investment objective	The objective of the Model Portfolio is to outperform the S&P/ASX 300 (TR) Index on a rolling 3 year period by 3% per annum.
Benchmark	S&P/ASX 300 (TR) Index
Number of stocks	15-35 (34 as at 30 June 2022)
Sector limits	A-REITS 0-30% Cash 2-10%
Dividend Yield	4.90%#
Income target	No target

Top 10 holdings

Code	Name	Weight
BHP-AU	BHP Billiton Limited	12.50%
CSL-AU	CSL Limited	8.94%
TLS-AU	Telstra Corporation Limited	6.91%
STO-AU	Santos Limited	6.52%
CBA-AU	Commonwealth Bank of Australia	5.79%
WBC-AU	Westpac Banking Corporation	4.77%
QAN-AU	Qantas Airways Limited	4.13%
NAB-AU	National Australia Bank Limited	3.85%
XRO-AU	Xero Limited	3.81%
QBE-AU	QBE Insurance Group Limited	3.12%

Source: Pendal as at 30 June 2022

Top 5 overweights versus S&P/ASX 300

Code	Name	Weight
STO-AU	Santos Limited	5.55%
TLS-AU	Telstra Corporation Limited	4.48%
QAN-AU	Qantas Airways Limited	3.89%
XRO-AU	Xero Limited	3.15%
MTS-AU	Metcash Limited	2.71%

Top 5 underweights versus S&P/ASX 300

Code	Name	Weight
WES-AU	Wesfarmers Limited (not held)	-2.41%
TCL-AU	Transurban Group Ltd. (not held)	-2.10%
ANZ-AU	Australia and New Zealand Banking Group Limited	-2.04%
WOW-AU	Woolworths Ltd. (not held)	-2.01%
RIO-AU	Rio Tinto Limited (not held)	-1.97%

Source: Pendal as at 30 June 2022

#The Portfolio's dividend yield represents the weighted average 12-month forward-looking dividend yield of the portfolio holdings (excluding cash), as at the date of the Factsheet. Each individual security's dividend yield is calculated using market consensus Dividend Per Share (DPS) before tax and franking credits, collated by Pendal and divided by the closing market price of the security as at the date of the Factsheet. The portfolio dividend yield therefore is only an estimate, and does not reflect the actual returns of the Fund, which will be affected by market movements in the price of individual securities, the returns on other assets such as cash holdings and variances of individual security's actual dividends from the forecasted DPS.

Performance

	1 month	3 month	6 month	1 year	3 year (p.a.)	5 year (p.a.)	Since inception (p.a.)*
Pendal Australian Shares Portfolio	-9.37%	-11.45%	-9.01%	-6.38%	5.57%	7.92%	8.39%
S&P/ASX 300 (TR) Index	-8.97%	-12.22%	-10.39%	-6.78%	3.43%	6.90%	6.71%
Active return	**-0.40%**	**0.77%**	**1.38%**	**0.39%**	**2.14%**	**1.02%**	**1.69%**

Source: Pendal as at 30 June 2022

*Since Inception - 15 June 2015

Performance returns are pre-fee. Investors should contact their platform provider for applicable fee rates.

Past performance is not a reliable indicator of future performance.

Top 5 contributors - monthly

Code	Name	Value Added
TLS-AU	Telstra Corporation Limited	0.35%
MTS-AU	Metcash Limited	0.20%
QBE-AU	QBE Insurance Group Limited	0.20%
CSL-AU	CSL Limited	0.15%
ALL-AU	Aristocrat Leisure Limited	0.14%

Top 5 detractors - monthly

Code	Name	Value Added
QAN-AU	Qantas Airways Limited	-0.41%
JDO-AU	Judo Capital Holdings Limited	-0.28%
EVN-AU	Evolution Mining Limited	-0.26%
WOW-AU	Woolworths Ltd.	-0.22%
TCL-AU	Transurban Group Ltd.	-0.22%

Top 5 contributors - 1 year

Code	Name	Value Added
APT-AU	Afterpay Limited	0.93%
S32-AU	South32 Ltd.	0.79%
STO-AU	Santos Limited	0.70%
VEA-AU	Viva Energy Group Ltd.	0.66%
MTS-AU	Metcash Limited	0.57%

Top 5 detractors - 1 year

Code	Name	Value Added
XRO-AU	Xero Limited	-1.65%
NEC-AU	Nine Entertainment Limited	-0.78%
WDS-AU	Woodside Petroleum Ltd	-0.55%
JHX-AU	James Hardie Industries	-0.55%
FMG-AU	Fortescue Metals Group Ltd	-0.51%

Source: Pendal as at 30 June 2022

Underweight positions are in italics.

Stock specific drivers of monthly performance relative to benchmark

Three largest contributors

Overweight Telstra (TLS, -0.8%)

Telstra held up much better than the broader market in June as investors sought defensive exposure. The company announced price increases across mobile phone contracts, to take place from July. Improvement in this division underpins a more predictable outlook for the company's earnings and cash flow, which should be seen favourably in the current environment.

Overweight Metcash (MTS, -1.6%)

Metcash benefited from the rotation to defensives in June. It delivered a strong set of results late in the month. The IGA franchise division continues to do well, holding share and benefiting from strong food inflation. Liquor revenue grew 9% for the year. Hardware also continue to do well, with strong DIY demand driving further growth off an already strong base. Earnings beat consensus expectations, as did the dividend.

Overweight QBE Insurance (QBE, +1.0%)

The insurance sector has generally outperformed in the last few months, as higher bond yields should provide a tailwind for margins. At the same time, premium pricing have been rising, helping offset rising claims inflation and structural issues posed by higher provisioning and reinsurance costs for weather-related events. QBE has done better than the domestically-focused insurers, where the market has been concerned about exposure to recent flooding events.

Three largest detractors

Overweight Qantas (QAN, -18.9%)

Concerns that the tightening cycle could drive the US economy into recession weighed on cyclicals in S&P 500, including on airline stocks and travel-related Australian stocks such as Qantas followed suit. A trading update from QAN late in the month Confirmed that demand remains strong. It reduced capacity in order to offset high fuel prices and continued to reduce debt ahead of schedule.

Overweight Judo Capital (JDO, -29.8%)

Judo is a challenger bank focused on lending to small-to-medium enterprises, a sector where the major banks have historically had less focus. It came off in June on broader concerns about the risk of a recession. This, along with stock coming off escrow in August, may cloud the near-term outlook. Longer term, the structural opportunity remains attractive, with a strong management team and good strategy.

Overweight Evolution Mining (EVN, -38.0%)

Gold miners are faced with a squeeze as cost inflation - for labour, diesel and power - continues to rise while the price of gold has remained steady. This has dragged on the gold mining sector as a whole, though EVN took an additional hit as management downgraded production guidance as Covid has disrupted labour supply. EVN remains among the lowest cost gold producers.

Outlook

The portfolio finished the month behind the index. Some of the more cyclical positions dragged as the market expressed concern over recession. There was an offset from defensive exposures in consumer staples and telecom.

We maintain a cautious near term outlook for equities. It is increasingly hard to see how the US avoids a recession from here.

First the lagged effect of inflationary pressures means we are unlikely to see much relief on this front given the fuel, food, and shelter components are still rising. This gives the Fed little room to back off hikes. Second, while overall economic activity remains reasonable, the lead indicators are deteriorating.

These include the “rule of ten” observation of mortgage rates and petrol prices - which has a good track record of predicting recessions – and falling house prices which can affect consumption. This is feeding through to a fall in the Altanta Fed’s GDP tracker and other GDP forecasts rolling over.

This economic risk has implications for the market. The market is currently discounting a material drop in earnings, while the latter continue to hold up. Since 1987 we have only seen this disconnection twice, in 2002 and 2011, where markets overstated risk.

However in 2000, 2008 and 2020 the earnings caught up with the market and therein lies the risk if the US and global economy go into a recession.

Valuations in the markets other than the US - including Australia - are lower and provide some protection. But we remain wary of how the market performs as downgrades come through.

While the risk is material, this bearish scenario is not a certainty. Factors which could see a better outcome include:

- Inflation momentum slows more quickly than now expected. There are some signs of hope with higher inventory at US retailers and evidence of discounting appearing. The fall in the oil price is a very important lead if sustained.
- Labour markets loosen up sooner. We have seen announcements from the tech sector on layoffs, but collectively this is not sufficient. On the supply side perhaps inflation and the crypto bust help drive participation higher.
- Supply chains begin to ease up as China re-opens and demand softens.

Should these factors start to play out we may see the Fed swerve again and not be as aggressive on rates. It would still be unclear whether this is enough to avoid a recession; but in the market’s eyes it would at least signal the depth of the downturn could be lower.

One flag which is likely to mark the low in this cycle is the passing of time. This market looks closer in nature to 2000 and 2008 where the market had to consolidate near its lows for a number of months before sentiment improved – unlike the sharp policy-driven bounce of 2020.

This is a challenging environment for portfolio construction, however we believe it plays to the strength of our approach.

Our strategy is underpinned by identifying mis-priced stocks by “anticipating change,” and building a portfolio that manages thematic risk and is primarily dependent on stock-specific alpha – rather than a particular macro pathway or outcome – to perform.

Both elements can be seen in the way we approach portfolio construction in this environment. We have a range of thematic exposures, such that performance is not dependent on a particular outcome or pathway in terms of the key macroeconomic uncertainties currently at play.

Within this framework, we are finding stocks which have a company-specific aspect which can support valuation and/or drive outperformance. A key element of this at the moment is an emphasis on pricing power and of cash flow that has resilience even if we do see economic momentum start to slow.

New stocks added and/or stocks sold to zero during the month

Sell to zero in Oz Minerals (OZL) and buy a new position in Suncorp (SUN).

We are lightening the portfolio’s commodity exposure, selling out of the position in copper miner Oz Minerals (OZL).

As the Fed increasingly demonstrates the commitment to bring inflation back towards their target level, the risks of overtightening and a recession in the US are rising materially. This is exacerbated by the focus on inflationary measures which are lagging indicators and also by the fact that material components of the CPI baskets – such as food and energy prices – are largely beyond the Fed’s influence to control.

A recession is not a certainty; there is still a possibility of a “soft landing.” The nature and severity of any recession is also another area of debate.

Nevertheless, this uncertainty is starting to be reflected in the prices of commodities such as copper, given the possible impact of a recession on demand.

The risk to the US is compounded by continued uncertainty over the outlook for China, another large user of copper. Here, Beijing is trying to support economic growth within the constraint of zero-Covid, with a highly uncertain outcome. At this point, it appears that recent policy measures are more about halting the deterioration in growth expectations, rather than trying to stimulate a recovery.

In addition to this macro risk, we are seeing higher cost inputs via diesel, electricity and wages along with challenges on labour availability starting to affect production and margins.

While the structural outlook for copper remains intact, it is being swamped by these concerns. We also note that copper is still trading well above pre-Covid levels, unlike some other commodities. As a result, we consider it prudent to lighten this exposure. The portfolio retain resource exposure via Iluka (ILU), South32 (S32), BHP (BHP) and Santos (STO).

This capital is being deployed in a new position Suncorp (SUN).

Suncorp Group Limited is a Queensland based conglomerate with operations spanning Banking, General Insurance and Life Insurance.

We are increasingly constructive on the insurance sector. The market has been focused on risks around storm activity and inflation. These issues are real, but in our view, more than offset by rising interest rates, higher pricing, internal cost out initiatives and discounted valuations. The portfolio has an existing position in QBE (QBE), however a strong case can now be made for SUN, which was sold off heavily following recent floods.

After three years of share price weakness SUN started to find its feet in 2022. Underwriting margins stopped falling, confidence in the outlook improved given efficiency targets, and interest rates started to rise. It was looking encouraging until floods struck south eastern Queensland and Northern NSW in Q1 2022. The market's concern is that SUN will need to pay more for reinsurance and also need to lift peril budgets. However this now appears largely reflected in consensus, which is already allowing for a 1% margin headwind on perils. Historically the budget has tended not to move by more than 1%, with room for insurers to argue conditions will improve.

The other hot topic is emerging claims inflation. This is already coming through home and motor supply chains, and will become a risk to liability classes as wages rise. However this is not a problem if passed on via price.

With regard to pricing, premiums have been increasing across the sector to reflect claims inflation and higher budgets for catastrophes. At this point we expect the industry to remain rationale in terms of price.

SUN should also benefit from high rates. Investment portfolio will be marked lower in upcoming results (given higher corporate spreads and lower equities). However once that subsides, margins should benefit from the pickup in running yields. At this point be believe that consensus expectations do not reflect the full extent of the tailwinds that SUN will receive from higher bond yields.

At the same time that SUN is benefiting from both cyclical and company-specific tailwinds, valuation is also undemanding in a historical context. It is trading on a 6.6% dividend yield.

For more information contact your
key account manager or visit **pendalgroup.com**