

Pendal Monthly Commentary

Pendal Australian Shares Portfolio

December 2022

Market commentary

Australian equities finished the year on a softer note, as central banks maintained a hawkish tone on inflation into the end of the year.

The S&P/ASX 300 fell -3.3% in December, giving back some of the gains of the previous two months. However it still finished up 9.1% for the quarter and down only -1.8% for the year. The S&P 500 fell -17.9% for the year, in contrast, highlighting the ASX's defensive qualities in this environment.

The US consumer price index (CPI - a measure of inflation) print for November was 0.2% month-on-month. This was down from 0.3% in October and was the second consecutive month where the increase was lower than consensus expectations. This, along with other signals, suggests that inflation continues to moderate.

However the US labour market remains strong and continues to concern the Federal Reserve. They need to see more slack in labour markets to calm fears about persistent wage increases driving further inflation. As a result, Chair Powell's comments following the interest rate hike in December emphasised the need to continue hiking - and to potentially keep rates high for longer than the market currently expects - until the labour market starts to soften.

Elsewhere, Beijing rolled back the zero-Covid policy. This has prompted some optimism around commodity prices on the hope that the disruptive economic effect of recurring lock-downs will end. Iron ore rose 15.7% for the month. However it is also seeing substantial near-term disruption and risks to the health system.

Every sector lost ground in December. Materials (-1.1%) held up better than the broader index on the back of higher commodity prices and optimism about the medium-term outlook for improved Chinese demand. BHP (BHP, +0.2%) held its ground, while fellow iron ore plays Rio Tinto (RIO, +6.2%) and Fortescue (FMG, +5.8%) made solid gains.

Utilities (-1.2%) also outperformed, helped by corporate actions as Origin (ORG, -1.8%) remains under a non-binding, indicative takeover offer.

Consumer Discretionary (-7.0%) fell the furthest on broad concerns over the impact of an economic slowdown in 2023. Wesfarmers (WES) was down -5.5%, Aristocrat (ALL) -12.9% and JB Hi-Fi (JBH) -6.1%.

Industrials (-4.9%) was also among the weaker sectors. A continued hawkish tone weighed on the infrastructure names such as Transurban (TCL, -7.3%) and Atlas Arteria (ALX, -6.0%).

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.
Benchmark	S&P/ASX 300 (TR) Index
Number of stocks	15-35 (30 as at 31 December 2022)
Sector limits	A-REITS 0-30% Cash 2-10%
Dividend Yield	4.21% [#]
Income target	No target

Top 10 holdings

Code	Name	Weight
BHP	BHP Group Ltd	12.40%
CSL	CSL Limited	8.52%
STO	Santos Limited	6.96%
TLS	Telstra Group Limited	6.67%
CBA	Commonwealth Bank of Australia	6.54%
WBC	Westpac Banking Corporation	5.70%
NAB	National Australia Bank Limited	5.49%
QAN	Qantas Airways Limited	5.18%
QBE	QBE Insurance Group Limited	3.63%
XRO	Xero Limited	3.55%

Source: Pendal as at 31 December 2022

Top 5 overweights versus S&P/ASX 300

Code	Name	Weight
STO	Santos Limited	5.85%
QAN	Qantas Airways Limited	4.65%
TLS	Telstra Group Limited	4.52%
XRO	Xero Limited	3.09%
QBE	QBE Insurance Group Limited	2.70%

Top 5 underweights versus S&P/ASX 300

Code	Name	Weight
ANZ	ANZ Group Holdings Limited (not held)	-3.30%
WDS	Woodside Energy Group Ltd (not held)	-3.14%
WES	Wesfarmers Limited (not held)	-2.43%
RIO	Rio Tinto Limited (not held)	-2.02%
WOW	Woolworths Group Ltd (not held)	-1.91%

Source: Pendal as at 31 December 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	-3.60%	7.44%	7.43%	-2.25%	6.39%	7.37%	8.85%
S&P/ASX 300 (TR) Index	-3.29%	9.13%	9.62%	-1.77%	5.51%	7.10%	7.55%
Active return	-0.31%	-1.69%	-2.19%	-0.48%	0.88%	0.27%	1.29%

Source: Pendal as at 31 December 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
QBE	QBE Insurance Group Limited	0.19%
TLS	Telstra Group Limited	0.15%
<i>PLS</i>	<i>Pilbara Minerals Limited (not held)</i>	<i>0.09%</i>
XRO	Xero Limited	0.08%
<i>TCL</i>	<i>Transurban Group Ltd. (not held)</i>	<i>0.08%</i>

Top 5 contributors - 1 year

Code	Name	Value Added
BHP	BHP Group Ltd	1.04%
QAN	Qantas Airways Limited	0.81%
STO	Santos Limited	0.63%
<i>SQ2</i>	<i>Block, Inc. Shs (not held)</i>	<i>0.54%</i>
<i>WES</i>	<i>Wesfarmers Limited (not held)</i>	<i>0.54%</i>

Source: Pendal as at 31 December 2022

Underweight positions are in italics.

Top 5 detractors - monthly

Code	Name	Value Added
DOW	Downer EDI Limited	-0.40%
NEC	Nine Entertainment Co. Holdings Ltd	-0.18%
<i>RIO</i>	<i>Rio Tinto Limited (not held)</i>	<i>-0.17%</i>
MIN	Mineral Resources Limited	-0.14%
ALL	Aristocrat Leisure Limited	-0.11%

Top 5 detractors - 1 year

Code	Name	Value Added
XRO	Xero Limited	-2.25%
JHX	James Hardie Industries PLC	-1.39%
<i>WDS</i>	<i>Woodside Energy Group Ltd (not held)</i>	<i>-0.92%</i>
NEC	Nine Entertainment Co. Holdings Ltd	-0.85%
DHG	Domain Holdings Australia Ltd.	-0.66%

Stock specific drivers of monthly performance relative to benchmark

Three largest contributors

Overweight QBE Insurance Group (QBE, +4.4%)

Global insurer QBE maintained its recent positive momentum. It is a beneficiary of higher interest rates as it boosts returns on its investment portfolio. This tailwind was confirmed in a recent update, with fixed income yields running well ahead of consensus estimates. Revenue momentum remains strong and the stock is cheap compared to global peers.

Overweight Telstra (TLS, +0.3%)

Telstra's defensive qualities were rewarded in December as investor sentiment softened. News that the Australian Competition and Consumer Commission (ACCC) blocked TLS's deal with TPG Telecom to share regional network capabilities weighed on the stock in the month's second half, to see it end flat for the period. We continue to see further upside from improved free cash flow following cost reductions.

Three largest detractors

Overweight Downer (DOW, -28.2%)

Contractor DOW downgraded FY22 net profit after tax (NPAT) by ~12%. This was driven largely by weather disruption and issues with workforce management. However 3% was due to an accounting irregularity which had overstated profits on one contract. The large market reaction as driven by concern that this could be a broader issue. The company has largely exited higher-risk, fixed-price construction contracts and believe the issue is not replicated, but is investigating. It has a good balance sheet, is buying back shares and should see a strong recovery in earnings in FY24. A strategic review could unlock further shareholder value.

Overweight Nine Entertainment (NEC, -12.4%)

Online real estate company Domain (DHG) downgraded earnings guidance for the half, citing a challenging environment and material declines in listing numbers. This weighed in turn on guidance on for NEC, which owns a 60% stake in the company. The broader business continues to perform well. There is some softening in the television advertising market, however this has largely been offset by gains in market share as programming performs well. We continue to see attractive valuation for a company with good free cash flow and further growth opportunities in its digital assets.

Underweight Pilbara Minerals (PLS, 19.5%)

The lithium mining sector has been under pressure since mid-November over concerns around softer Chinese demand for electric vehicles. This was exacerbated by the results of PLS's December auction for lithium spodumene concentrate cargos, which saw slightly lower realised prices than in November - the first time prices have fallen in some time.

Underweight Rio Tinto (RIO, +6.2%)

Iron ore prices rose 16.7% in December as Beijing rolled back Covid restrictions. This is likely to see significant near term economic disruption and presents a risk to health systems. Over the longer-term, it has prompted optimism that the disruptive effects of ongoing lock-downs will disappear. Iron ore miners such as Fortescue Metals, Rio Tinto and BHP outperformed as a result.

Outlook

The portfolio lagged the index return in December. Some of the more cyclical exposures dragged - notably Downer and Nine Entertainment. This offset strength in QBE Insurance and Telstra, as well as relative resilience in Xero.

There are six key questions leading into 2023.

- 1) The persistence of inflation, which will determine how tight financial conditions need to be.
- 2) The scale of economic slowdown in the US and other developed markets.
- 3) The leverage of earnings to that downturn.
- 4) Whether markets have already priced in the downturn.
- 5) How China's economy performs as it exits covid-zero
- 6) Can the RBA engineer a soft landing in Australia.

Initial signs on the first three issues are positive. The first datapoints of the year suggest that inflation is lower than consensus expectations, which in turn requires less tightening, a milder downturn and a small hit to earnings.

The deceleration in wage growth is now evident. After December's pay roll print, three month annualised wage growth now stands at 4.2% and annual growth at 4.6%.

The Fed will still want to see these figures below 4%, but it is likely to lock in a 25bp rate hike in February unless we see a dramatic deterioration in CPI numbers this week,

This supports market in the near term. So too does the current outlook for China.

The consensus view has been for markets to re-test equity low points in the first quarter as earnings revisions turn negative. As a result investor positioning has been cautious, with the market braced for a poor reporting season. Ironically, this may lead to the market holding up better than expected.

That said, it is hard to see a sustained market move materially higher. The Fed is likely to rein in any substantially easing of total financial conditions - which includes equity markets. The economic downturn is still also likely, with earnings set to fall. A market multiple of 17x in the US does not provide much of a buffer to this.

It is important to note that, after persistent increases in the expected peak in Fed rates through most of 2022, the market has now stabilised at a ~5% level since October.

This coincided with the US market low and may suggest that the de-rating phase may be over, with economic downturn and the impact on earnings becoming the key issue from here.

There have been material earnings downgrades going into the US Q4 CY22 earnings season. Overall earnings per share (EPS) growth is expected to be flat year-on-year. But if the energy sector is stripped out, they are expected to be down 5%.

Usually when the market is braced for negative outcomes, it is in the price for the short term.

On the flip side, the market has held up better going into this reporting season compared to previous quarters, which suggests less scope for a relief rally.

All this is consistent with a US market trading towards the high end of recent ranges, but no break higher in short term.

The Australian market retains its defensive qualities in this environment, with China's re-opening potentially offering a further leg of support.

The portfolio has exposure to domestic defensives with predictable cash flows and strong industry positions which can protect against a weaker economic environment. Telstra is one example here. We also like companies such as Nine Entertainment where strong free cash flow is being returned to shareholders, with buybacks helping support stocks. The portfolio retains exposure to companies with pricing power supported by favourable industry structures, which can help protect margins against inflation risk. Qantas and QBE are examples of these.

We are also mindful that a new development could see a shift in policy and bond yields fall again. As a result we maintain exposure to growth stocks such as Xero and CSL, where we have good visibility on the growth opportunity and high incremental returns on invested capital.

Finally, we have selected high quality cyclical exposures. These are sensitive to the economic cycle, but are ultimately winners in their industry and provide portfolio protection against the risk of a milder economic cycle than consensus is currently pricing.

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

No new stocks added or sold to zero during the month.

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

PENDAL

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