Investment Newsletter – May 2023

All eyes are on the bottom-line

ALL ABOUT PROFITS & DIVIDENDS NOW

In the coming months, investors are expected to shift their focus from seeking growth in revenue and share prices to concerns regarding the profitability of the companies in which they invest.

In previous investment letters, we have been stating that inflation was the big concern for markets, and companies with pricing power would be better positioned to pass on inflationary pressures to their revenues, and win the day. This prediction has largely played out. This was at a time when consumption in the economy was holding up to absorb the price increases and allowed companies to continue delivering revenue growth.

However, inflation is now pulling back to our estimated range of 4-6% (still a big question mark whether it will fall to 2% desired by the Reserve Bank of Australia). When you combine disinflation with general negative growth outlook for consumption (i.e. pull back in volume) the impact on companies' revenue could well result in net-negative growth. Consequently, the only thing the companies can control in this slowing environment are costs and protect profits to the extent they can. Those who can protect their profits, it will be a relative game, and protect/maintain dividends will win favour from investors in the months ahead.

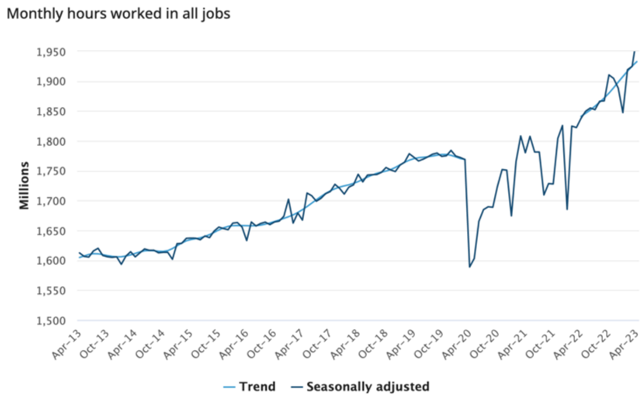
Why is inflation pulling back? *Well, it is pretty clear now that the central bank (RBA) will likely succeed in shifting the economy into neutral gear (neither growing nor contracting), temporarily disconnecting it from the wheels that run it. The four wheels that run our economy are energy (power), labour, commodities, and interest rates (cost of capital). With inflation running as high as it has been it was abundantly clear that the rubber on all four wheels was wearing dangerously thin and causing the economy to overheat (i.e. inflation). It was thus a natural response from the regulators to engineer a slow down by shifting down the economic speed and allow for the rubber (capacity) to grow back on the wheels and prevent the economy from oversteering up or down.*

There is a growing but subdued sentiment among investors that this orchestrated slowdown is progressing according to plan. However, there is still some time before we offer a ticker tape parade to the central banks. We will only know for sure with the passage of time when looking back at these years.

PROFIT PROTECTION – SIGNS ARE BEGINNING TO EMERGE

As mentioned earlier, cost cutting is one sure way to protect profits and dividends. Faced with the probable risk to revenue in the months ahead, the first place you will start to see businesses cut back is in employment. We don't have to look far for evidence as the recent data from the Australian Bureau of Statistics (ABS) for the month of April reveals that businesses have started to trim their labour force. In total, Australian businesses let go 27,100 full-time employees in April, causing the unemployment rate to grow slightly from 3.6% to 3.7%. Despite these job losses, the overall employment market remains tight, indicating a fully employed economy. We interpret these job losses as more a case of companies gearing up for protecting their profit margin as opposed to a response to any drastic reduction in demand. The reason we come to this conclusion is that if you look at the number of hours worked per employee, it has actually risen in April. This tells us that remaining employees are being tasked with shouldering a greater workload to compensate for the workforce reduction.

Figure: Monthly hours worked in all jobs)



Source: ABS, May 2023

The trimming of full-time jobs has not been specific to any particular sector; rather, it has been observed across various sectors. Here are some examples that we have identified from the past month:

1. **Australia Post** (Postal Services): The company plans to cut 400 roles from its Melbourne head office, including executive level, general managers, and heads of departments. However, no frontline roles will be impacted. The company is facing significant structural headwinds, including declining letter volumes due to increasing uptake of technology.

2. **Culture Amp** (Software/Technology): The Melbourne-based software start-up, recently valued at $2 billion, is laying off 9% of its staff, impacting around 100 roles. The company had raised $100 million in funding in 2021, but is facing softening market conditions.

3. **Woolworths** (Retail/Grocery): The grocery giant is cutting several dozen jobs, although it is considered one of the most resilient Australian businesses.

4. **Atlassian** (Software/Technology): The Australian technology giant announced it was slashing 500 jobs from its global

operations in March, becoming the latest casualty of the "tech wreck" sweeping the sector.

5. **KPMG Australia** (Professional Services): One of the big four accounting firms, KPMG Australia, had pinned 200 roles for redundancy due to a drop-in demand from clients due to worsening economic conditions.

Our aim in the coming months is thus to be vigilant about the risks to profits and dividends and, to the extent possible, manage exposure to companies with a high risk to earnings.

GLOBAL MARKETS OVERVIEW

		Month End	Price Performance (% Chg)			
	Units	Value	1-day	1-mth	6-mths	1-year
Developed Markets Equities						
ASX 200	AUD	7,309	0.22%	1.83%	6.49%	-1.69%
ASX 200 Futures	AUD	7,318	0.38%	1.77%	7.49%	1.02%
Dow Jones	USD	34,098	0.80%	2.48%	4.17%	3.40%
S&P 500	USD	4,169	0.83%	1.46%	7.68%	0.91%
Stoxx Europe 600	EUR	467	0.56%	1.92%	13.21%	3.61%
FTSE 100 (UK)	GBP	7,871	0.50%	3.13%	10.94%	4.32%
DAX (Germany)	EUR	15,922	0.77%	1.88%	20.13%	12.94%
CAC (France)	EUR	7,492	0.10%	2.31%	19.54%	14.66%
Nikkei 225	JPY	28,856	1.40%	2.91%	4.60%	7.48%
Emerging Markets Equities						
MSCI Emerging Markets	USD	977	0.50%	-1.34%	15.20%	-9.21%
Shanghai Composite	CNY	3,323	1.14%	1.54%	14.85%	9.06%
South Korea	KRW	2,502	0.23%	1.00%	9.07%	-7.18%
Taiwan	TWD	15,579	1.09%	-1.82%	20.30%	-6.11%
Brazil	BRL	104,432	1.47%	2.50%	-10.00%	-3.19%
South Africa	ZAR	72,583	0.07%	2.96%	20.91%	10.85%
Foreign Exchange						
AUDUSD	Currency	0.6615	-0.24%	-1.05%	3.38%	-6.32%
AUDGBP	Currency	0.5266	-0.76%	-2.84%	-5.69%	-6.23%
AUDEUR	Currency	0.6005	-0.13%	-2.61%	-7.24%	-10.33%
AUDCNY	Currency	4.57	-0.39%	-0.44%	-1.83%	-2.49%
Commodities						
LME ALUMINUM 3MO ($)	USD/mt	2,356	1.60%	-2.36%	6.03%	-22.82%
LME COPPER 3MO ($)	USD/mt	8,596	0.10%	-4.42%	15.38%	-12.02%
LME NICKEL 3MO ($)	USD/mt	24,219	0.50%	1.60%	11.05%	-23.77%
SILVER FUTURE Jul23	USD/oz	25.23	0.07%	3.60%	28.84%	6.38%
ICE Newc Coal Fut Jun23	USD/mt	187.60	-0.48%	-8.80%	-39.85%	-11.59%
62% Import Fine Ore in USD	USD/t	106.49	-0.46%	-12.54%	34.95%	-20.29%
Gold Spot $/Oz	USD/oz	1,990	0.11%	1.05%	21.82%	4.91%
WTI Oil	USD/bbl	76.78	2.70%	1.29%	-4.03%	-10.61%
Henry Hub	USD/mmBtu	2.27	4.61%	8.10%	-54.78%	-66.79%
Corn	USD/Bu	636.00	1.44%	-3.71%	-8.03%	-22.27%
Wheat	USD/Bu	619.75	0.81%	-10.47%	-29.75%	-40.62%
Fixed Interest						
10-Yr Bond Yield						
Australia	AUD	3.34%	-0.03%	+0.04%	-0.42%	+0.21%
US	USD	3.42%	-0.10%	-0.05%	-0.63%	+0.49%
Germany	EUR	2.31%	-0.15%	+0.02%	+0.17%	+1.38%
Japan	JPY	0.39%	-0.07%	+0.04%	+0.15%	+0.16%
Italy	EUR	4.18%	-0.18%	+0.08%	-0.12%	+1.40%
Australian Rates						
Cash Rate	AUD	3.60%	+0.00%	+0.00%	+1.00%	+3.50%
90-Day BBSW	AUD	3.68%	+0.02%	-0.03%	+0.59%	+2.98%
180-Day BBSW	AUD	3.86%	+0.04%	+0.06%	+0.19%	+2.42%
CBOE Options						
CBOE VIX (Volatility Index)	Index	15.78	-7.34%	-15.61%	-39.03%	-52.75%

Data as of 30 April 2023

ECONOMIC NEWS

• **In Australia** After pausing its almost year-long tightening cycle in April, RBA resumed monetary policy tightening in May, increasing its cash rate to 3.85%, the highest level since April 2012. Further policy tightening is likely ahead as Governor Philip Lowe announced the bank can't take "too long" to bring inflation back down to its 2-3% target. Economic growth (GDP) forecast for 2023 is +1.2% while 2025 forecast is +1.7%.

• **Global growth outlook.** IMF downgraded world GDP growth forecast for 2023 to +2.8% (advanced economies +1.3%, U.S. +1.6%, Euro +0.8%, Japan +1.3%, China +5.2%, India +5.9%).

• **In US -** The Fed raised rates to 5-5.25%, the highest level since 2007, and hinted it may be the final move in its tightening campaign as it omitted a line from its previous statement in March that said the committee "anticipates that some additional policy firming may be appropriate" while Fed Chair Jerome Powell signalling that Fed officials' outlook for inflation does not support rate cuts. However, the market continued to price in around 1-in-3 odds of a cut as soon as June with a cut by July fully priced in.

Economic growth deaccelerated in March Quarter 2023 to +1.1% as the slowdown driven by an inventory drawdown was partially offset by acceleration in consumer spending, however, inflation remained sticky with the Fed's preferred core gauge of prices picking up to +4.9%, the quickest pace in a year. Nonfarm payrolls rose 253k in April leading to unemployment rate falling to a multi-decade low of 3.4%, with average hourly earnings rising +0.5% per month (+4.4% p.a.). Consumer confidence dropped in April to the lowest since July on more pessimistic views about the economic outlook as year-ahead inflation expectations jumped by the most in nearly two years, rising to 4.6% and 5-10 year inflation expectations ticked up to 3%, first increase in 5-months.

• **In China –** Economy grew at the fastest pace in a year in March Quarter 2023 to +4.5% p.a., however, manufacturing index (PMI) in April slipped to contraction territory with sub-indexes for new orders, new export orders and manufacturing employment contracting over the month, leading to Communist Party's Politburo announcing to keep economic policy stance largely unchanged, signalling it's too early to pivot toward tighter monetary and fiscal measures or push contentious economic reforms as growth rebounds, while vowing to provide more support for private companies.

• **In Europe -** ECB raised the deposit rate to 3.25%, the highest level since 2008, and announced it expects to halt reinvestments under its Asset Purchase Program as of July, while vowing further tightening of monetary policy to bring rates to levels sufficiently restrictive to return inflation to the 2% target, despite ECB President Christine Lagarde forecasting corporate earnings, that are increasingly being blamed for driving euro-area inflation, to continue to decline. Euro-zone headline inflation accelerated to +7% p.a. in April driven by services prices and a less favourable annual comparison for energy costs, however, core-CPI eased for the first time in 10-months, rising +5.6% p.a.

• **In Japan** BOJ maintained policy, including stimulus measures, while scrapping its guidance on future interest-rate levels and calling for a long-term review of its policies, as it indicated it has more confidence in much-awaited wage increases for 2023 with the results of the wage talks so far suggesting sizable gains not only among large businesses but also for smaller companies.

GLOBAL MARKETS

• **US markets.** US markets were stronger in the month, with the Dow Jones up +2.5% and S&P500 up +1.5%.

• **Long-dated US treasury yields** were mixed, with the 2-Yr yield higher at 4.04% and 10-Yr yield lower at 3.42%.

• **European markets** were higher with the Stoxx Europe 600 Index up +1.9%, UK FTSE up +3.1% and German DAX up +1.9%.

• **Asian markets were higher**, with Nikkei up +2.9%, KOSPI up +1.0% and Shanghai Composite up +1.5%.

• **ASX performance.** The ASX200 gained +1.8%.

• **Commodities.** WTI oil price gained +1.3% to US$76.78/bbl, as slowing flows from Russia, production cuts by OPEC+ and falling US inventories pointed to a tightening market

THE LONG READ

INVEST IN THE FUTURE OF OUR CHILDREN

In this article, we would like to shift the focus from investing for ourselves to investing for our child(ren).

As parents we get incredibly busy attending to the needs of our children in the here and now, ranging from quality and costly schooling to other lifestyle related expenses.

However, what we often forget is the importance of maintaining a savings and investments fund for our children. The purpose of such a fund is to be a genuine wealth builder for the child. They are not allowed to touch the funds for the next twenty years and at that time they may use the funds to invest in real assets but they cannot use the lump-sum to fund consumption.

The fund will have the following fundamental investment guidelines:

1. The fund will be locked for twenty years i.e. can't sell positions or take the money out
2. Savings will be made into a brokerage account on a monthly basis – and investment purchases will be quarterly. We leave it to you to decide your own annual investing goal but we are thinking $10k p.a.
3. The fund will lock in four long term themes and invest in them every three months
4. Market timing and near-term economic forecasts are to be entirely ignored
5. The fund will only invest in ETFs as it's the easiest way to get scale and diversification at low cost
6. The fund cannot sell existing positions
7. Review the strategies every 5 years and confirm the thesis for each theme
8. Involve the child over the investing term, encourage them to read-up about the impact of the themes their portfolio is investing in and discuss the portfolio with them as they grow older

The next step is the exciting part, which is to pick the themes to select for the portfolio. We want this investment experience to be as much about risk mitigation through investing in diversified ETFs as much as the opportunity to imagine the future and help shape it with own money.

In twenty years, we will likely have a world with mostly electric cars driving around on lithium batteries. We believe robots trained on AI will be in the mainstream. The NASDAQ Index could will become the main value creation engine of the US stock market on the back of accelerating digitalisation of societies, explosion of AI, and computing power. And finally, India could will become even more significant growth engine for the global economy in the decades ahead. Let's quickly review each of these themes in bit more detail below.

#Transition to a low carbon emissions world

You may remember that after the global financial crisis of 2008 the Australian economy went into a period of record low inflation and low interest rates for the next ten years. You may also remember that economic pundits were telling us that we are in a perpetually low growth cycle where there is simply not many exciting investment and growth opportunities around. People's wages went sideways for a long time and labour was underutilised.

So, with that uninspiring recent economic past if there was ever going to be a gift of massive and totally global investment opportunity then look no further than the transition of the world's dependence on fossil fuels-based energy to renewable forms of energy which includes electrification of cars and other road vehicles. There have been plenty of big numbers thrown around for the level of investment required to enable this transition. According to Mckinsey & Co. (Management Consultancy) there will need to be $275 trillion of investment required to be made between now and 2050 to successfully transition to a renewable energy run society. That is over 3x the size of the entire annual size of the world economy today! This is an immense level of globally coordinated and required investment, and it will start to ramp up from here on. Australia is expecting to have 85% of its energy consumption sourced from renewable sources within the next seven years.

Road transport contributes 12% of global greenhouse gas emissions from the burning of petrol and diesel in cars, trucks, lorries, motorcycles and buses. 60% of road transport emissions come from passenger travel (cars, motorcycles and buses); and the remaining 40% from road freight (lorries and trucks). This means that, if we could electrify the whole road transport sector, and transition to a fully decarbonized electricity mix, we could feasibly reduce global emissions by 12%. For the purposes of this exercise, assume the expenditure on the value chain of electric batteries therefore requires 12% budget from the $275 trillion estimated above. ***This equates to $1.2 trillion annual investment in lithium battery value chain alone. That is every year for the next 27 years!***

For this reason, we are going to invest in an ETF that invests in a range of companies involved in the lithium battery value chain. The companies included in this ETF include lithium mining companies to battery producers.

#Nasdaq 100 index will be the main engine of economic value in future

Over the past decades, the technology industry has judiciously been developing the core capabilities in software applications, hardware devices such as smartphones, data capturing, developing algorithms for machine learning, and increasing the computing power. All these individual forces and innovations are starting to converge and set to accelerate in the years ahead. We can't yet fully comprehend how vast and pervasive the change will be at all levels of society due to this digitalisation but if the past ten years of smart phones was a teaser then we truly have an exciting future ahead of great innovations which will make our lives that much more enriching and productive. Companies like Microsoft, Amazon, Google will be seen more like massive utilities and essential defensive stocks rather than just high growth stocks. For this reason, we would much rather own NASDAQ 100 index based etf than a S&P500 index etf which will likely have a lot of companies that will get disrupted by technology.

#Incredible India

India will surprise a lot of people in the coming decades after it emerges from being in China's shadow of the past two decades. India has a tremendously high calibre skilled and educated workforce and when you consider it in the context of a population of over a billion people then this labour pool can become a powerhouse engine for its economy. India also has one of the youngest demographics in the world so it can sustain high rates of economic growth for decades to come while other advanced economies deal with their ageing population. India is also the largest democracy in the world and it has played a deft hand at balancing its interest in keeping peace and trade links with China & Russia on one side and US & allies on the other. India will be the winner in the increasingly political divide between China and the US. Indian shares have delivered a solid return over the past decades and we see these are set to continue for its economy is on a fundamentally sound footing.

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