Entrust

Quarterly report

June 2023

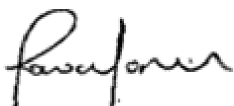
Summary

- Over the course of the 2023 Financial Year equity markets have delivered strong returns despite a long list of seemingly negative events.
- Global equity markets displayed a wide dispersion in returns, serving to underline the benefits of a diversified portfolio.
- Notably US markets performed much more strongly than the ASX200 due largely to its significantly higher weighting to technology and technology-related stocks; a sector to which Australia has little exposure.
- We are starting to see some (irrational?) exuberance in the US market on the back of excitement around Artificial Intelligence or "AI". The poster-child of which, Nvidia, has seen ~200% gains this calendar year, joining the "Trillion dollar" club.
- On the economic front, interest rates continue to rise, to be well above initial market expectations.
- These rate rises, which serve to re-direct consumer income away from expenditure on consumption is finally starting to show its effects with a number of ASX retailers recently providing weak trading updates.
- Notwithstanding increased interest rates and tighter credit conditions, Australian house prices have started to bounce back as low rental vacancies and increased costs of construction now collide with a return to strong population growth.
- Looking forward, consistent with our March commentary, we think equity market valuations look reasonable, outside of some renewed exuberance in the US tech sector. We continue to see good opportunities to generate solid, low-risk returns from a range of income-based assets (e.g., Bank Hybrids, Government Bonds, Private Credit etc.).

The enclosed commentary provides greater insight into our thoughts.

Thank you again for entrusting the management of your portfolios to the Entrust team. Should you have any questions on your portfolio or investment markets in general, please give us a call.

Kind Regards



Rowan Jones

Head of Entrust Wealth Management

Resilience

"Nobody can predict interest rates, the future direction of the economy, or the stock market."

These words of wisdom from investment legend Peter Lynch have certainly rung true over the course of the 2023 Financial Year (FY23).

Notwithstanding everything thrown at financial markets over the last 12 months, equity markets have proven remarkably resilient. The list of things that investors were within their rights to worry about over the past year, is reminiscent of Billy Joel's 1989 hit "We Didn't Start the Fire":

- Inflation
- Interest rates
- UK Pension funds
- FTX collapse
- Chinese economics
- US banking crisis
- Geopolitics
- Credit Suisse AT1's
- US debt ceiling
- Russians in the Ukraine

This period echoes the long-term history of markets ultimately continuing their upward march as shown in ***Chart 1***, which we reproduce from our 2022 Year in Review.

Chart 1 – Equity Market Resilience Over the Long-Term

Source: BT

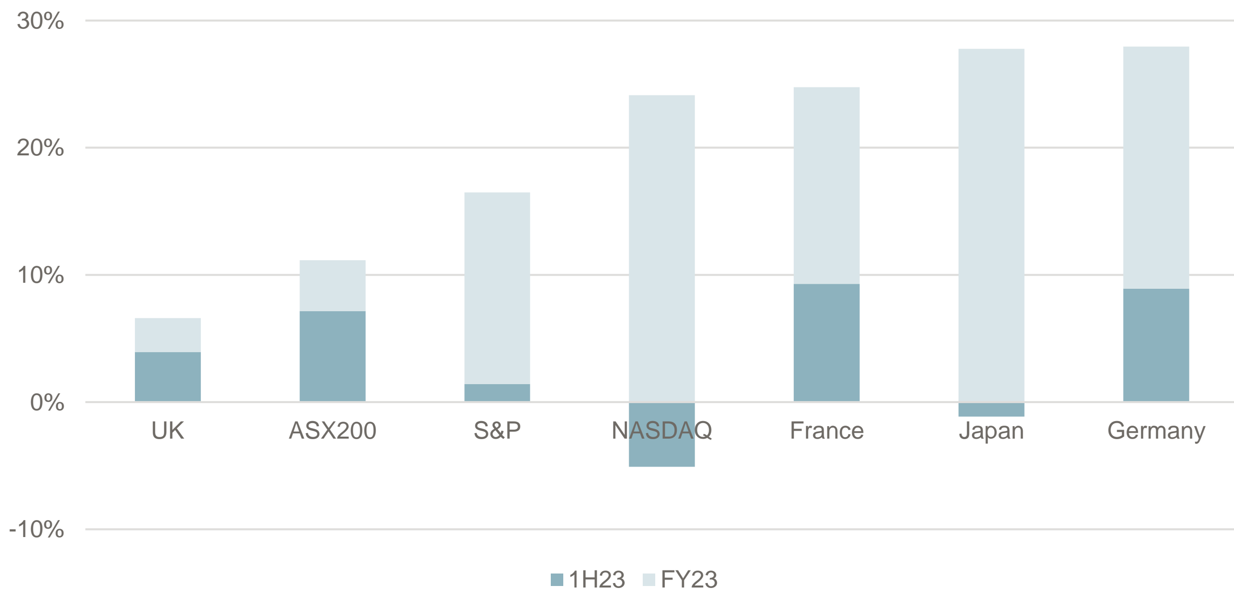
Equity Market Performance

The performances of the major global equity markets in FY23 are shown below (***Chart 2***), highlighting the wide dispersion of returns across markets.

Notably the German and French markets have performed very strongly over the last year, recovering from poor performance in the first half of calendar 2022, due in large part to concerns related to the Russian invasion of Ukraine.

The Japanese market is up 28% in 2H23, though the index still sits ~10% below its peak reached in 1989 (this is not a misprint).

Chart 2 – FY23 – Global Equity Market Performance



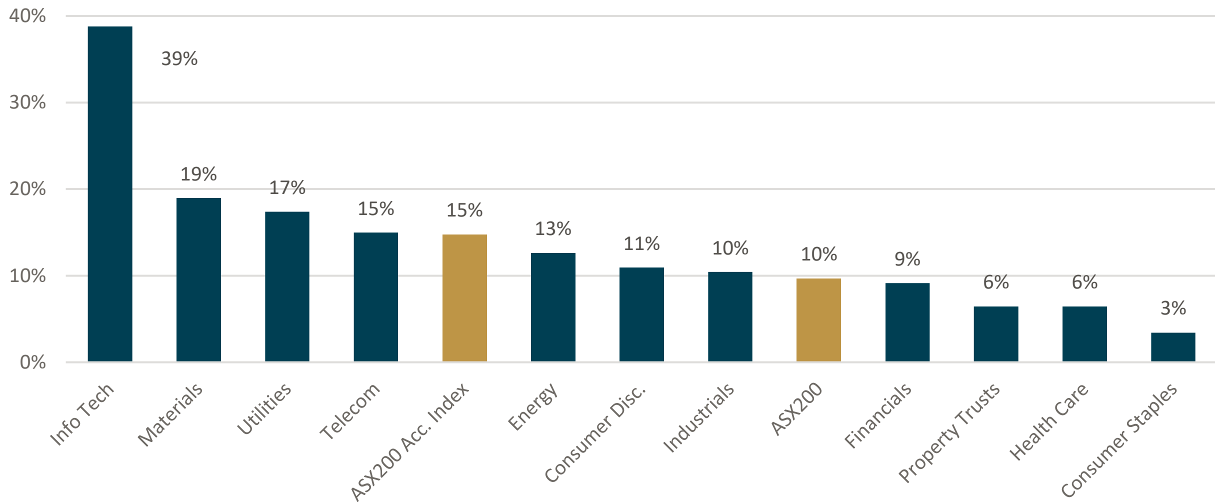
Source: IRESS

ASX200

Over the year to June 2023, the ASX200 recorded a gain of ~10% while the ASX200 Accumulation Index (i.e., inclusive of dividends) was up ~15% (***Chart 3***).

All sectors recorded gains, led by the 39% increase in the Information Technology sector.

Chart 3 – ASX200 Sector Performance to June 2023



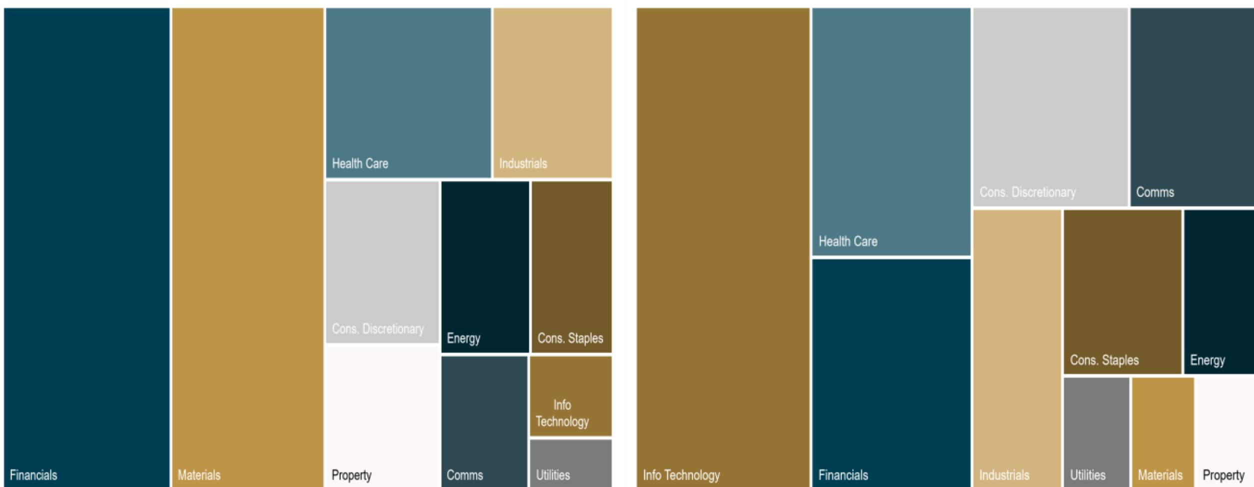
Source: IRESS

Australia v US

As shown in ***Chart 4***, there has been a large discrepancy between the performance of the Australian and US markets (S&P500 and NASDAQ) during FY23. A key to understanding this is to recognise the vastly different composition of the two markets. ***Chart 4*** shows the sector weightings of the ASX200 (left hand side) and S&P500 (right); key differences of note, include:

- Information Technology comprises 28% of the S&P500 and only 2% of the ASX200.
- Materials (i.e., largely Resources) and Financials (i.e., largely Banks) comprise a combined 50%+ of the ASX200, yet only ~15% of the S&P500.

Chart 4 – Market Exposures



Source: FactSet, Charlie Bilello

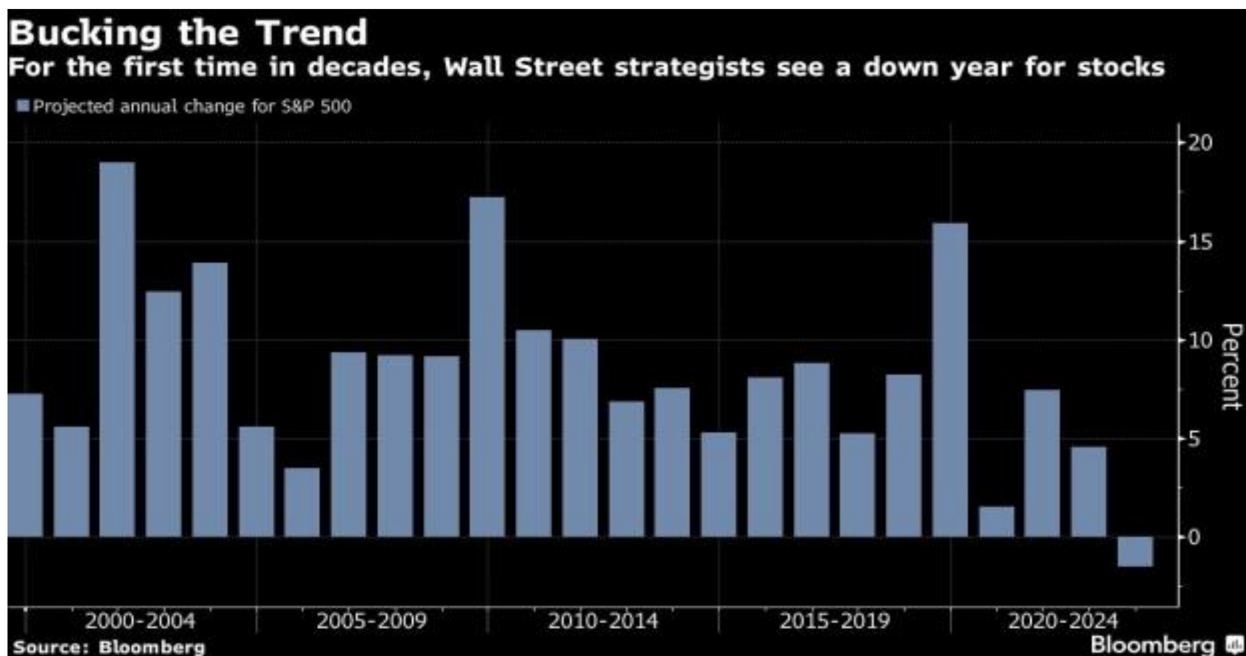
Benefits of Diversification

The large, divergent (and generally unpredictable) moves that are seen in various markets from time to time underline the benefits in constructing an investment portfolio diversified by asset class and geography.

US Markets Surprise to the Upside…

In support of Peter Lynch's statement that opened our commentary, it is interesting to note that the 15% gain in the S&P500 represents one of its strongest starts to a calendar year since the late 1990's. This despite Wall Street strategists predicting, for the first time since the turn of the century, that the S&P500 would deliver a negative return in calendar 2023 (***Chart 5***) – though, we note, there is still half a year to go, and anything can happen.

Chart 5 – Wall Street Strategist Predictions



Source: Charlie Bilello

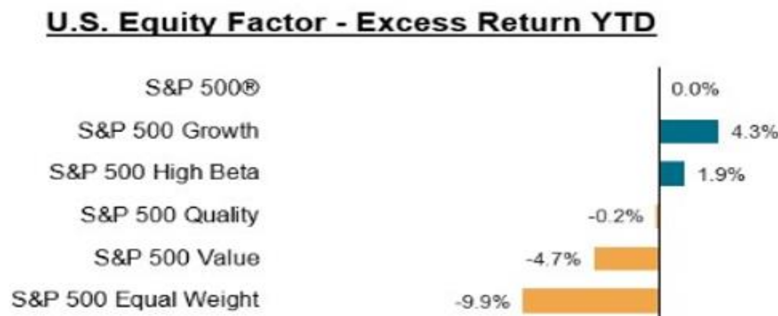
…Though Gains Have Not Been Broad-Based

The large weighting to technology and technology-related stocks, particularly the "Mega-Caps", has driven the recent strong performance of the S&P500.

The S&P500, as are most indices, are market weighted, meaning that the larger stocks have a larger weighting. As such, their stock price moves have a larger influence on the change in the level of the overall index.

Highlighting how "narrow" the gains in the S&P500 have been, were all stocks equally weighted (as opposed to market weighted), the Index would have generated a return 9.9% lower than the overall index (***Chart 6***) in the period to 29 May 2023.

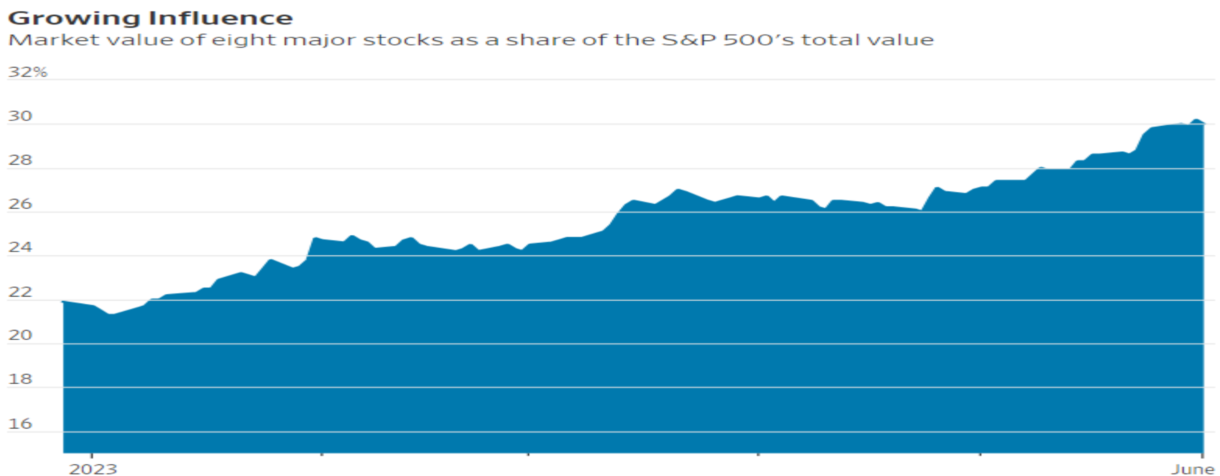
Chart 6 – S&P500 Performance Drivers



Source: Firstlinks *(NB. Data to 29 May 2023)*

The performance of the Mega-Caps now sees the eight largest stocks in the S&P500 (Alphabet, Amazon, Apple, Meta, Microsoft, Netflix, Tesla and Nvidia) comprising 30% of the index, up from 22% at the start of the year (***Chart 7***).

Chart 7 – 30% of S&P500 Value is Comprised of Less Than 2% of Stocks



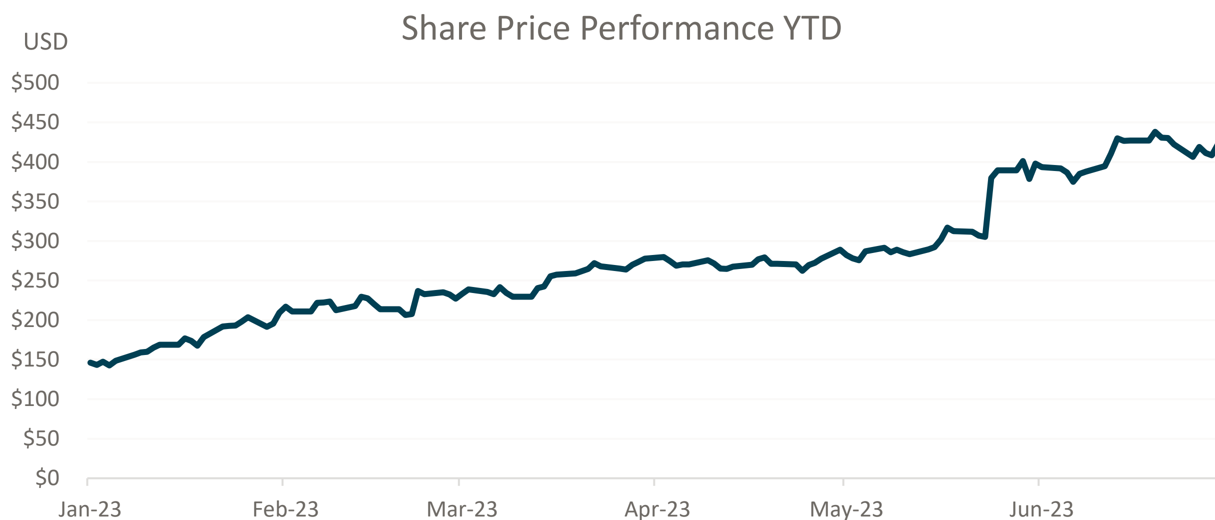
Source: Charlie Bilello

Artificial Intelligence Captivates Investors

The US technology sector recently hit an all-time high, having bounced more than 50% from its recent lows in October 2022.

The rapid emergence of, and excitement around, Artificial Intelligence (AI) has captivated investors. The poster child for this excitement being chipmaker, Nvidia Corp, shares in which have risen by ~200% since the start of the year (***Chart 8***).

Chart 8 – Nvidia



Source: IRESS

Nvidia's market capitalisation has soared to over US$1 trillion (that's trillion with a "T") joining this exclusive club alongside other US tech heavyweights Apple, Microsoft, Alphabet (the parent of Google) and Amazon.

The valuation applied by the market implies that Nvidia is trading on ~25x its forecast revenue. To put this into some form of perspective we reach back to the tech boom and bust of the late 1990's, early 2000's. One of the tech-darlings of this period Sun Microsystems traded at up to 10x revenue (well below that at which Nvidia currently trades) prompting this classic 2002 post-bust quote from Scott McNealy, Sun Microsystems co-founder.

'At 10 times revenues, to give you a 10-year payback, I have to pay you 100% of revenues for 10 straight years in dividends. That assumes I can get that by my shareholders. That assumes I have zero cost of goods sold, which is very hard for a computer company. That assumes zero expenses, which is really hard with 39,000 employees. That assumes I pay no taxes, which is very hard. And that assumes you pay no taxes on your dividends, which is kind of illegal. And that assumes with

zero R&D for the next 10 years, I can maintain the current revenue run rate. Now, having done that, would any of you like to buy my stock at $64? Do you realize how ridiculous those basic assumptions are? You don't need any transparency. You don't need any footnotes. ***What were you thinking?****'*

Only time will tell, whether Nvidia will generate acceptable investment returns for those investors willing pay 25x revenue today to get in on the AI excitement.

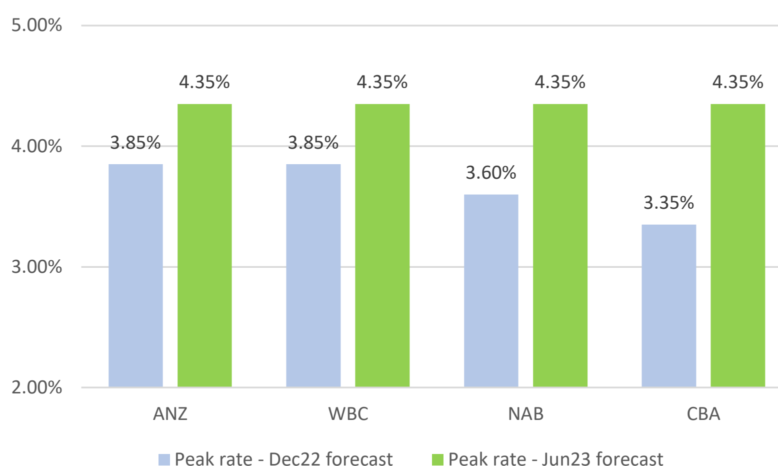
Inflation & Interest Rates

Inflation and interest rates have garnered significant attention over the last 18 months, with the one constant being that expectations around the levels of both have continued to rise as underlying economies have to date shown remarkable resilience. With reference to the experience in Australia and the US, we believe that there have been two key drivers behind this continued strength:

- the high level of savings built up during the COVID period, when consumers were showered with Government cash in various forms, and
- the ongoing high employment levels in both countries, with continued high levels of job vacancies indicating that this strength may continue for some time.

Following rate rises in each of May and June, the official cash rate in Australia has now risen to 4.10%, well above the peak level expected by economists from the Big 4 banks only a few months ago (***Chart 9***).

Chart 9 – Interest Rate Expectations Continue to Rise

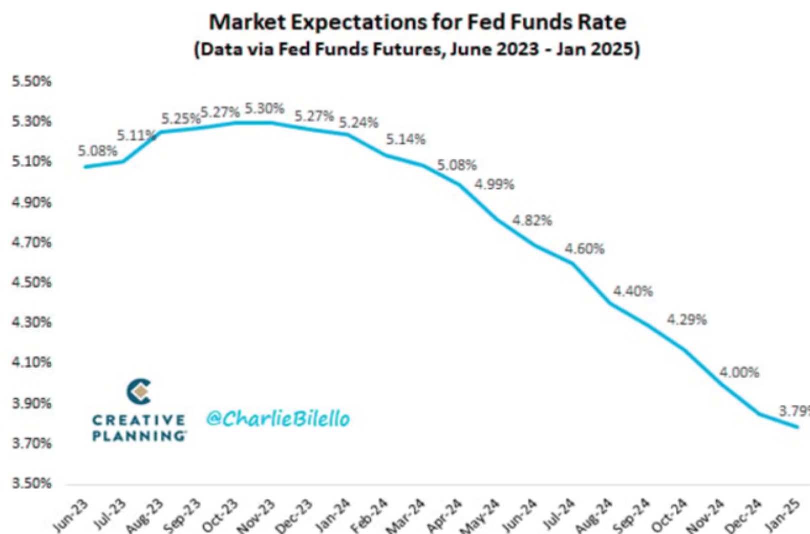


Source: Canstar

In the US, the Federal Funds target rate now sits at 5.00% - 5.25%, with the Federal Reserve members on balance forecasting a further 0.50% of increases, which would bring the target rate to

5.50% - 5.75%. Notwithstanding this, US markets continue to price in a relatively sharp reversal in interest rates (***Chart 10***).

Chart 10 – Implied Market Pricing of US Federal Funds Rate



Source: Charlie Bilelo, Creative Planning

Should We Pay Any Attention to Forecasts?

Collectively, there is much time, energy and brainpower expended by economists, investors and the like trying to predict the course of interest rates. With strong equity market performance over the last year, notwithstanding much higher interest rates, maybe these predictions (irrespective of whether they prove to be right or wrong) just don't matter.

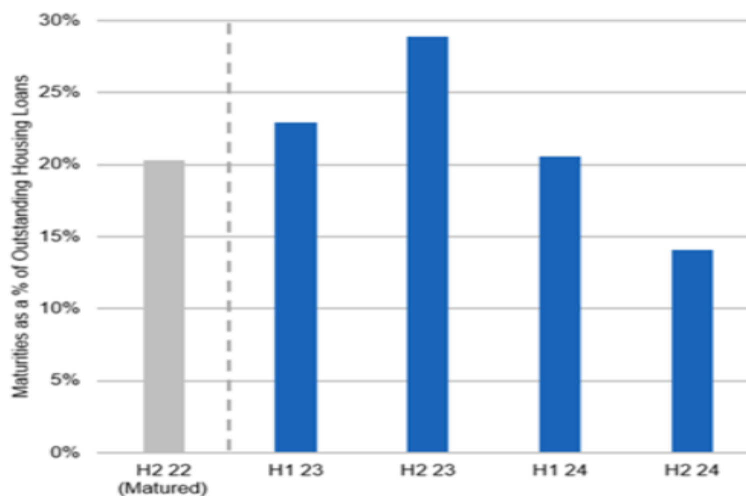
In response to a recent question regarding the potential hit to GDP were a credit crunch to occur on the back of the US banking crisis, Warren Buffett replied *"I've been in business running Berkshire Hathaway for 58 years and I've never opined an economic forecast of any use to the company…., if I depended in my life on economic forecasts, you know, I don't think we'd make any money. I don't know how to do it. And, you know, people want to get them (economic forecasts), so they get them. But it has no utility. When I find one of our companies has hired somebody to tell them what's going to happen in the economy, I mean, they're throwing their money away as far as I'm concerned."*

Housing Costs and the Impact on Consumption

One clear observation (as opposed to a forecast) from the increasing interest rate environment is that a larger share of income and /or savings that mortgage holders / renters will become directed to meeting commitments such as mortgage repayments or rental increases. Previously this income and savings were available for consumption.

Holders of variable rate mortgages have gradually been feeling the impacts of these rate rises as Banks have passed them on. In addition, across the remainder of 2023 and into 2024 the majority of fixed-rate loans written at the time of much lower interest rates will roll off and generally require refinancing at much higher interest rates (***Chart 11***).

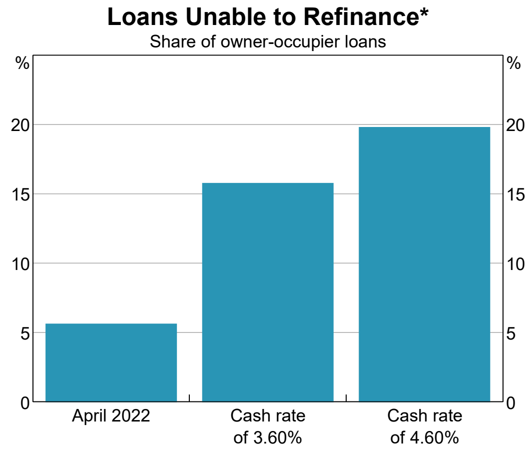
Chart 11 – Fixed Rate Mortgages Rolling Off



Source: PIMCO

According to RBA data, at the current cash rate of 4.10%, approximately 18% of owner-occupier borrowers would be so-called *"Mortgage Prisoners"*, that is, those unable to refinance their loans to meet serviceability assessments at current interest rates (***Chart 12***). These borrowers won't be turfed out onto the street – home loan arrears levels remain low and each of the major banks is proactively seeking to identify borrowers that may be struggling or will potentially struggle as rates rise, in order to provide assistance as appropriate.

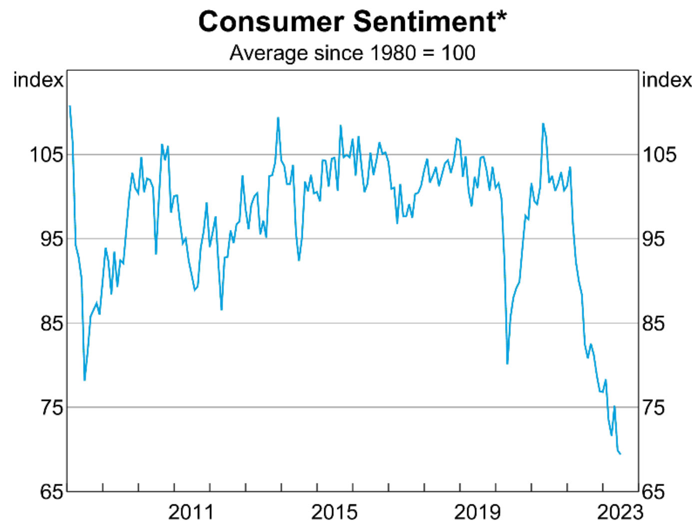
Chart 12 – "Mortgage Prisoners"



Source: RBA

The actual impact of these rate rises coupled with headlines in the newspapers and on television undoubtedly impact on consumer sentiment, which now, somewhat remarkably, sit at levels below those seen at the peak of COVID (***Chart 13***).

Chart 13 – Loans unable to be refinanced



Source: RBA

Lower Income + Poor Sentiment = Reduced Consumption

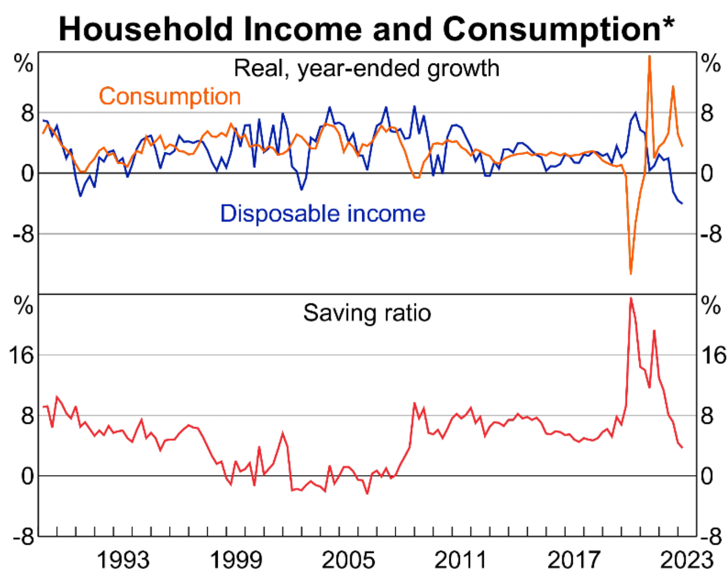
Unsurprisingly, less disposable income and poor consumer sentiment has led to declining consumption (***Chart 14***). It must however be noted that this decline in expenditure has been a long time coming (and from very high levels), with the consumer remaining remarkably resilient for much longer than many expected.

In recent weeks a number of ASX-listed discretionary retailers have provided weak trading updates (e.g., Universal Store Holdings, Michael Hill International, Domino's Pizza, Retail Food Group, Best & Less, Baby Bunting).

At its recent Annual Strategy Day, Wesfarmers observed that across its retail businesses (including Bunnings, Kmart and Target) customers had more and more been seeking value, which hadn't been as important a consideration in the immediate post-COVID period. As such, the Wesfarmers stable of retail businesses with their reputation for providing value through "everyday low prices" has reportedly been performing quite well.

Underlining how long it has taken for consumers to feel the pinch, we first highlighted in our June 2022 letter that some good quality retail stocks were starting to look interesting from an investment perspective. We remain on the lookout for opportunities should some of these quality names (e.g., JB Hi-Fi) see their share prices sold off.

Chart 14 – Consumption Finally Coming Under Pressure



Source: RBA

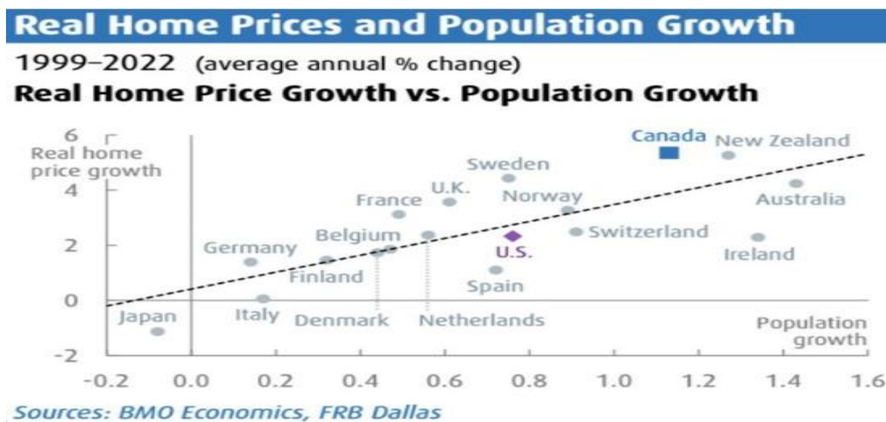
A House Price Conundrum

With increasing interest rates and decreasing borrowing capacity, the easy conclusion to draw would be falling house prices. CoreLogic reported that Australian property prices fell by 9% between May 2022 and February 2023, however since this time they have rebounded to be up 3% nationally over the prior quarter and down 6% over the year. In contrast, Perth house prices are up 2% over the past year.

A number of reasons can be offered for this bounce-back Australia-wide and lack of any real dip in Perth, including low rental vacancies along with the impact of supply chain issues which has seen increases to the time and cost of construction.

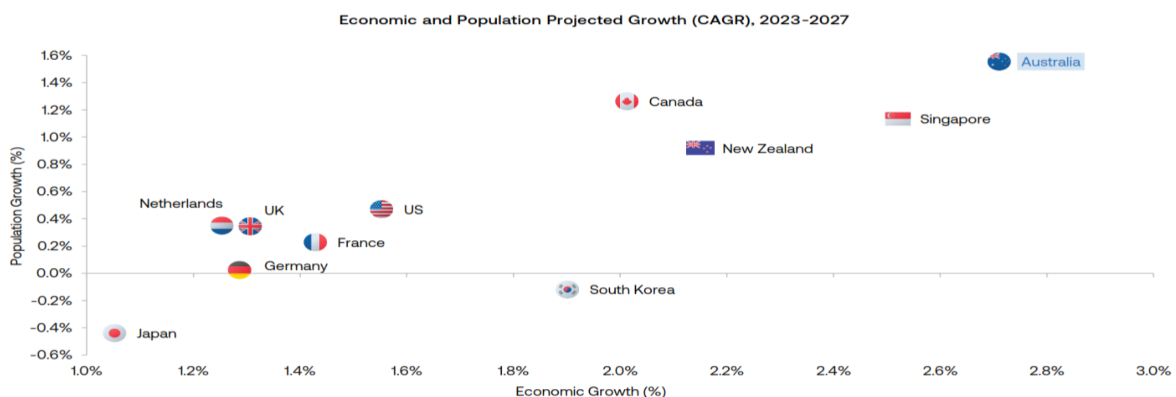
Additionally, the strong return of population growth, one of the key long-term drivers of property demand and price (***Chart 15***), is expected to continue over the medium-term (***Chart 16***).

Chart 15 – Population Growth = House Price Growth



Source: Firstlinks

Chart 16 – Projected Population Growth 2023 – 2027



Source: Charter Hall

Outlook

Over the course of the year, in managing client portfolios with an eye to protecting the downside, we have maintained a relatively cautious stance. This approach has been driven by the combination of:

- the uncertain outlook over the last 12 months, which as discussed earlier, markets have largely overcome, and
- the fact that the rising interest rate environment has provided good opportunities (e.g., Bank hybrids, Government bonds, etc.) to generate levels of returns sufficient to help in meeting client goals with lower levels of risk.

At all times we strive to manage client portfolios to the best of our ability as we aim to meet our client goals. We are humble enough to acknowledge that we do not know how markets will perform in any given period; the past year has been a good reminder of this - no matter the growing list of issues and against a backdrop of negative expectations from market professionals, the equity market has performed well.

As we look forward, consistent with our March commentary we think equity market valuations look reasonable, notwithstanding some signs of renewed exuberance in the US tech sector.

In regard to individual asset classes:

- We continue to see good opportunities to generate solid, low-risk returns from a range of income-based assets (e.g., Bank hybrids, Government bonds, Private Credit etc.).
- As we have discussed previously, we expect to see an inflection point for unlisted assets sooner rather than later. Where appropriate we have been reducing our exposure to unlisted assets over the last year.
- Conversely, we continue to see reasonable opportunity in listed property trusts where share prices have been materially impacted over the last 12-18 months.
- We expect (hope) to see opportunities to acquire good quality ASX-listed businesses, such as in the Discretionary Retail sector, if, some of these names get sold off on the back of concerns of a more difficult macro environment.

Stock in Focus – CSL Limited (ASX: CSL)

Each quarter we will provide a summary of a key portfolio holding. This quarter the stock in focus is CSL Limited. CSL was established in Australia in 1916 by the Federal Government and has grown to become one of the true success stories in Australian corporate history.

A key inflection point in CSL's journey was the 1990 appointment of Brian McNamee, a 33yr old trained doctor, as CEO. Mr McNamee led the 1994 privatisation of CSL, with the business listing on the ASX with a market capitalisation of ~$300m. Today CSL is Australia's third-largest listed company (behind only BHP and Commonwealth Bank) with a market capitalisation of ~$135bn, up over 400-fold since listing (***Chart 17***).

Mr McNamee stepped down as CEO in 2013, returning in 2018 to serve as Chairman, a role he continues to hold.

The history of the business has been one of extraordinary success. Looking to the future, we think that CSL is well-placed to continue to deliver ongoing earnings growth over the long-term in the high single, low double-digit range.

We expect this growth to be driven by the strong tailwinds that benefit many health care providers; that being the growing and aging population, coupled with the increasing awareness and diagnosis of disease.

In addition to this organic growth, CSL has developed a strong track record in making value accretive acquisitions. In late 2022 CSL completed the $17bn acquisition of Vifor, a global leader in the treatment of diseases associated with iron deficiency and nephrology (kidney diseases).

We note that acquisitions come with various risks and quite often do not go as planned. To date, CSL remains confident in the ability of Vifor to deliver in line with their initial expectations, we also draw comfort from CSL's strong track record in this regard.

Notwithstanding the many positives that we see with CSL, even the best businesses will experience challenges from time to time. Recently CSL provided guidance for Financial Year 2024 earnings growth of 13-18%. While these are very strong numbers, they were around 10% below the expectations of the market. The key reason behind the reduced guidance is the slower than expected recovery in margins in CSL's plasma business. Industry margins were impacted in this area as the supply of plasma (extracted from donor bloodstreams) was impacted during COVID, resulting in increased competition for plasma, serving to push up the prices paid to donors. These costs, coupled with other cost pressures related to supply chains and labour cost inflation have slowed the recovery in margins. We see this issue as something that CSL will continue to manage in the ordinary course of business as opposed to something more nefarious.

CSL has also recently appointed a new Managing Director in Paul McKenzie, who takes over the business from well-regarded CEO of ten years Paul Perrault. The departure of a well-performed CEO can sometimes be a cause for concern, despite the ultimate inevitability of a change being made. Similar concerns were understandably held upon the retirement of Mr McNamee and the appointment of Mr Perrault in 2013. Again, in this regard we draw comfort from CSL's approach to CEO succession with Mr McKenzie being an internal appointment, having joined CSL in 2019.

With the strong industry tailwinds, backed by CSL's considered long-term approach to business we consider CSL to be a core long-term portfolio holding.

Chart 17 – CSL (Blue Line) v ASX200 (Red Line)

Source: IRESS

Copyright and Distribution

The material contained in this communication (and all attachments) is prepared for the exclusive use of clients of Euroz Hartleys Limited (ACN 104 195 057) ("Euroz Hartleys") only. Euroz Hartleys is the holder of an Australian Financial Services Licence (AFSL 230052) issued by the Australian Securities and Investments Commission ("ASIC") and is a participant of the Australian Securities Exchange Group ("ASX Group").

The information contained herein is confidential and may be legally privileged. If you are not the intended recipient no confidentiality is lost nor privilege waived by your receipt of it. Please delete and destroy all copies, and contact Euroz Hartleys on (+618) 9268 2888. You should not use, copy, disclose or distribute this information without the express written authority of Euroz Hartleys.

Disclosures & Disclaimers

Euroz Hartleys and its associates declare that they deal in securities as part of their securities business and consequently may have a relevant interest in the securities recommended herein (if any). This may include providing equity capital market services to their issuing company, hold a position in the securities, acting as principal or agent, or make a market therein and as such may effect transactions not consistent with the recommendation (if any) in this report.

Euroz Hartleys declares that it may have acted as an underwriter, arranger, co-arranger or advisor in equity capital raisings, and will have received a fee for its services, for any company mentioned within this report during the last 12 months.

Euroz Hartleys Limited advises that any advice, statement of opinion, or recommendation contained in this document is provided by way of unsolicited general information only and has been prepared without taking account of your investment objectives, financial situation or particular needs.

You should not act on any recommendation issued by Euroz Hartleys without first consulting your investment advisor in order to ascertain whether the recommendation (if any) is appropriate, having regard to your investment objectives, financial situation and particular needs. Nothing in this report shall be construed as a solicitation to buy or sell a security, or to engage in or refrain from engaging in any transaction.

Euroz Hartleys believes that the information and advice contained herein is correct at the time of compilation, however we make no representation or warranty that it is accurate, complete, reliable or up to date, nor do we accept any obligation to correct or update the opinions in it.

The opinions expressed are subject to change without notice. No member of Euroz Hartleys accepts any liability whatsoever for any direct, indirect, consequential or other loss arising from any use of this material. We cannot guarantee that the integrity of this communication has been maintained, is free from errors, virus interception or interference.

Entrust