RESEARCH UPDATE

MARKET watch

JULY 2023

Apt. WEALTH PARTNERS

International markets continued the rally from May into June. The concerns around economic fundamentals and further Federal Reserve rate hikes did not deter US investors, with the S&P 500 Index and the Nasdaq Composite Index increasing by 6.5% and 6.6% respectively. The Hang Seng Index rallied 3.8% as China's government continues to use both monetary and fiscal policy to stimulate the weak Chinese economy. The S&P/ASX 200 Index underperformed international markets, increasing by 1.6%, with the Health Care sector the key detractor.

S&P/ASX 200 Sector Performance

The best-performing sector in June was Materials, driven in large part by the iron ore miners on hopes of further stimulus in China. Fortescue Metals Group, BHP Group Limited and Rio Tino Limited rallied by 15.4%, 7.7% and 7.2% respectively. Lithium miner Lake Resources Limited was the sector's worst performer, falling by 43.4% after the company provided a trading update which led to broker downgrades due to the combined impact of lower lithium prices and the Kachhi project being completed 12 months later than expected.

The Information Technology sector increased by 3.5% following a similar rally in US markets. US-based private family and friend social networking application provider Life360 increased by 11.6% following an update from management at the Annual General Meeting for subscription revenue to grow by 50% year on year and for the company to deliver positive operating cash flow of between $5 and $10 million in FY23. Life360 is also expected to remain positive, operating cash flow positive on a quarterly basis beginning in the second quarter of FY23. Xero Limited rallied a further 8.2% as the market continued to view the move by the new Chief Executive Officer to balance profitability and growth favourably.

Financials rallied by 3.1%, driven by Magellan Financial Group Limited, which increased by 20.3% despite disclosing $0.5 billion in retail net outflows for the month of May. Retail and wholesale insurance broker AUB Group Limited increased by 16.3% following the successful completion of a retail share purchase plan which raised $37 million, above the targeted $15 million, with the surplus expected to be returned to shareholders.

The Industrials sector fell by 0.6%, driven by John Lyng Group Limited, which declined by 16.2%

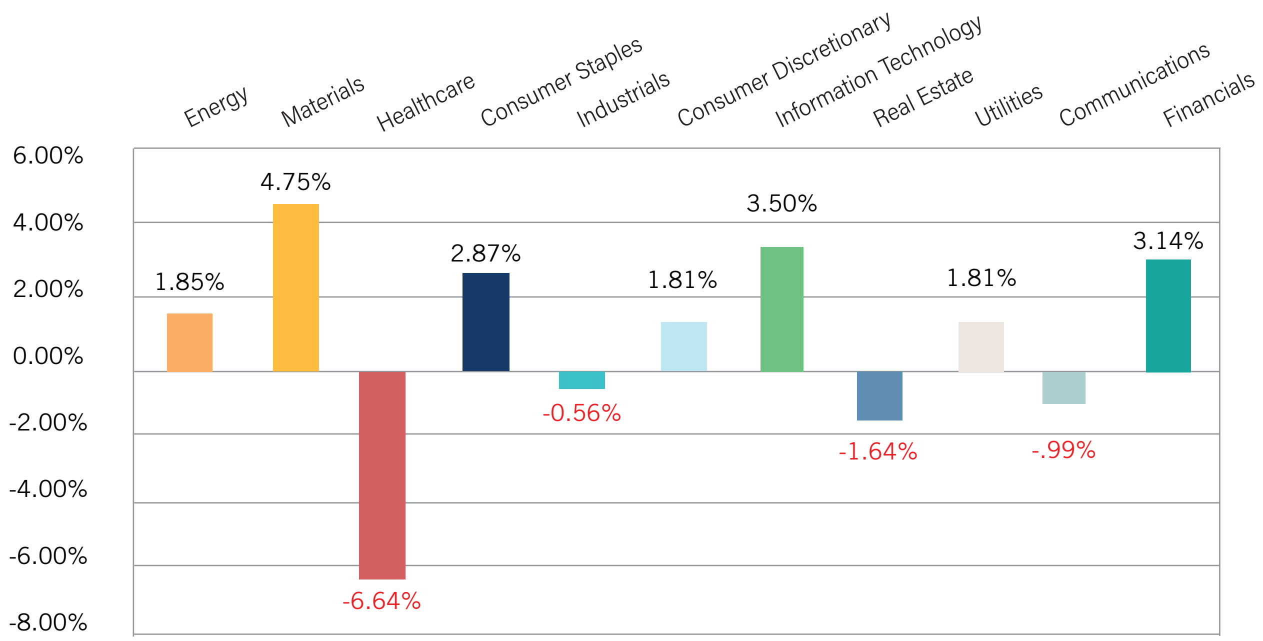
Apt Wealth Partners AFSL 436121 ABN 49 159 583 847

after releasing updated earnings guidance which disappointed the market. Management guided for normalised FY23 Earnings Before Interest Tax Depreciation and Amortisation to increase by 10% above previous guidance, driven by an increase in catastrophe activity, but this would be partly offset by a fall in commercial construction earnings due to the slowdown in the sector. Link Administration Holdings Limited declined by 12.8% after announcing the loss of industry super fund HESTA for its funds administration services. HESTA is expected to transition away in FY25 and contributed 4% of revenue in FY23.

TPG Telecom was the primary detractor from the Communications sector (-1.0%) after falling 11.0% following the announcement that the Australian Competition Tribunal had declined to authorise a regional networking sharing arrangement with Telstra. The agreement would have enabled Telstra and TPG to share each other's mobile towers, reducing the cost to service regional customers, but would have disadvantaged Optus.

Healthcare (-6.6%) was the worst-performing sector, driven by CSL Limited, which fell by 9.6% after providing a trading update, with the company now expecting a US$230 to US$250 million headwind from adverse currency movements in FY23, an increase from US$175 million at the time of the half-year result. On a constant currency basis, FY23 profit guidance remained unchanged but is expected to be at the top end of prior guidance, whilst FY24 Net Profit After Tax and Amortisation, although expected to grow by between 13% and 18% to US$2.9 billion to US$3.0 billion, was below some analyst forecasts. Cochlear Limited fell by 5.9% after the UK Competition and Markets Authority published its final report that although it would not oppose the acquisition of Oticon Medical, it would require Cochlear to divest Oticon's Medicals bone conduction implants business due to concerns it would lessen competition.

Graph 1: S&P/ASX 200 Sector Performance



Data Source: Desktop Broker, 3 July 2023.

Highlights

Australia: The Australian Bureau of Statistics (ABS) released the latest inflation reading, with the Consumer Price Index indicating a 5.6% increase for the 12 months to the end of May 2023, the smallest increase since April 2022. The most significant contributors to the annual increase were Housing (+8.4%), Food and non-alcoholic beverages (+7.9%), and Furniture, household equipment and services (+6.0%). An 8.0% decline in Automotive fuel was the main offset and prices fell 6.7% in the month of May, compared to a rise of 9.5% in April.

The ABS also reported that new housing loan commitments fell 2.9% in April 2023, with owner-occupier leading the decline at 3.8% with investor loans falling by 0.9%. The decline in new home loan commitments is likely due to higher interest rates, which has impacted how much people can borrow.

Office property valuations have been falling, driven by the combined impact of an increase of employees working from home and higher interest rates. It is difficult to ascertain the extent of the decline as there have been very few transactions which would otherwise give a clearer view of the current market price. The sale of a 50% stake in the Salesforce Tower, which overlooks Circular Quay in Sydney, was put on hold after bids from potential purchasers reportedly came in 10% below expectations. Large, listed office tower owner Dexus Property Group announced it had finalised the sale of a 26-storey A-grade office at 44 Market Street in the centre of Sydney to Hong Kong private equity company PAG for $393.1 million, a 17% discount to the December book value.

One of the large asset managers in the world, BlackRock Inc, has announced a $500 million investment to fund a giant grid-scale battery in Waratah, NSW. The Waratah Super Battery, located at the site of the former Munmorah coal-fired power station, has a targeted completion date of August 2025.

Japan: The Tokyo Stock Exchange has formally ordered all listed companies trading below book value to publish a plan to raise their price-to-book ratio (P/B) above 1x. The P/B is the current share price divided by the net asset value per share. Although companies have no control over the current share price, they do have some control over the net assets as instead of retaining surplus profits they can instead use profits to pay dividends or buy back stock, which would reduce the book value, in turn increasing the ratio. The median stock on the Tokyo Stock Exchange trades at just over 1x P/B, while the S&P 500 trades at 3.97x. The news has contributed to a rally in Japanese stocks.

US: The Commerce Department reported that new residential construction in the US increased significantly in May to an annual rate of 1.63 million starts from 1.34 million starts in April, a 13-month high. The report showed single-family housing starts increased by 18.5%, while multi-family housing starts increased by 27.1%. Economists had been predicting a further decline in housing starts, so the increase came as a surprise to markets. The number is often revised downwards in subsequent weeks, but if correct, reflects continued underlying strength in the US economy.

In contrast to office property, self-storage is seeing increased demand as more people work from home with a need to use storage as spare rooms are converted to home offices. Occupancy rates across the US have increased from 90% to 96%, with particularly high demand in Florida and Texas leading to high rental, which have increased by approximately 35% since 2020.

Pharmaceutical company Eli Lilly and Co has been trialling a weight loss drug that has shown to reduce body weights by 24% after 48 weeks, the highest body weight reduction seen in an obesity drug so far. This follows prior news of Danish pharmaceutical company Nova Nordisk A/S, which saw an average 15% reduction in body weight in participants following a 68-week clinical trial. The Nova Nordisk has been available to patients for over twelve months. The implications of these dugs could be significant, with cost savings for healthcare systems and improved quality of life for millions of people struggling with obesity. The drugs are not expected to have significant adverse health-related side effects, but there are still concerns about other unintended side effects due to the pathway for people to weight loss without any effort or care.

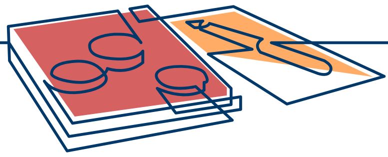
China: The Bureau of National Statistics reported that industrial firm profit fell by 18.8% year on year in the first five months of 2023 as companies were impacted by lower margins and softening demand following a weakening post-COVID economic recovery. Chinese Premier Li Qiang said the country would roll out more effective policy measures to expand domestic demand. Industrial profit and subsequent demand have a large impact on Australian resource exports.

What to watch out for

There are increased concerns about private equity valuations, in particular private equity valuations for leverage buyout (LBO) firms. A leveraged buyout is when a takeover of a company is largley financed with debt. As a result of the sharp increase in interest rates, the cost of serving loans have increased significantly, decreasing profits and valuations. As the companies are private, there is no current market price that can be observed, and a clearer view cannot be seen until the private company is sold.

Oil and gas prices have continued to fall despite cuts to oil production by Organisation of the Petroleum Exporting Countries (OPEC). The decline is being driven by lower expected demand as a result of the lower economic growth. There is also speculation that high oil prices over the last few years incentivised production in non-OPEC countries, such as from Brazil, Guyana, Argentina, Canada and Norway. The oil price was a major driver of inflation in 2022 and is the main driver of the lower headline inflation readings over the last few months.

Conclusion



International markets have rallied from the lows reached at the end of 2022, largley driven by the largest US-listed companies, with smaller companies and other international markets underperforming. Despite falling headline inflation due to lower energy prices, central banks continue to warn that inflation may be more 'sticky' than markets are expecting, which could result in cash rates rising further and staying higher for longer. Markets have rallied significantly since the 2022 lows; however, there are still high levels of uncertainty, especially around the prospect of a recession in most developed economies.

During periods of uncertainty, clients should:

- Stick to the plan: focus on your long-term goals. Our investment approach is focused on the long term and designed so that your portfolio can ride out any downturns – including this one. Staying the course, despite how uncomfortable it may feel right now, will prove to be the better option when looking back five years from now. Investors who stayed on the course while equity markets declined in the depths of the COVID-19 pandemic in early 2020 have benefitted from one of the fastest market turnarounds with equity markets. Investors who sold equities during the downturn and waited until economies started to show recovery before buying back into the market missed a large part of the recovery.
- Maintain a buffer of safety: holding a buffer of cash and term deposits has been a key strategy to provide a cushion against market downturns and to protect capital.
- Take advantage of the weakness: market downturns provide buying opportunities to invest in long-term, quality investments.

- Focus on quality investments: invest in companies that generate stable cash flows to support distributions, which are not connected to the movements in asset prices, and partner with Fund Managers that share the same investment philosophy and objectives.
- Ensure diversification: across assets classes, industries, sectors and geographies.
- Regularly rebalance the portfolio back to your risk profile: to ensure that the portfolio is not exposed to unwanted risks and to also lock in profits.
- Remain calm, speak to your Apt adviser: it is important that you speak to your Apt adviser before making any financial moves. Your adviser understands your long- and short-term goals and will have been planning for these types of scenarios already, so they are best placed to explain any impact and discuss the best options and opportunities for you personally.