Australian Equities Update

May 2021

This report has been prepared by Northcape Capital, the underlying investment manager for the Warakirri Ethical Australian Equities and Warakirri Concentrated Australian Equities Funds.

Market Review

Australian stocks rose 2.3% over May with the main areas of strength being banks (+7.3%) and healthcare (+3.5%). All the major banks provided trading updates in May with lower impairments driving earnings upgrades across the sector.

Technology (-9.9%) was the worst performing sector with material declines in the share prices of EML Payments (-41.9%) and Afterpay (-21.1%).

The sharp spike in input prices in recent months has raised concerns it will feed into higher inflation. Higher headline inflation numbers contributed to a sell-off in the bond market earlier in the year, impacting negatively on valuation of growth stocks.

However, these concerns have eased as evidence emerges that supply chains are returning to normal. The critical issue in the inflation debate is the extent of spare capacity in the economy, particularly in the labour market. This is difficult to measure but policy makers appear satisfied there is sufficient slack to allow current low interest rate settings to be maintained.

This is supportive of equity valuations, especially in the context of the strongest earnings upgrade cycle seen in many years. However, the margin of safety has diminished as share prices have pushed higher.

Market Outlook

The pace of economic recovery in Australia and abroad is accelerating in response to unprecedented fiscal and monetary stimulus. In Australia we have an unusually high savings rate as overseas travel has not been an option over the last year and international borders are unlikely to re-open until mid-2022.

This should result in buoyant consumer spending in the year ahead. While the vaccine rollout has been slow to start, momentum is building and full vaccination by end of 2021 is looking more plausible if current run rates continue to improve.

Investors have perceived the economic and health risks relating to the pandemic to be receding, resulting in a "risk on" mindset. This is creating a tailwind for equity and commodity markets, although may also heighten risk in some sectors of the market.

Earnings momentum in cyclical sectors continues to be revised up and further upgrades could be expected for the major miners if spot commodity prices are sustained. Free cash flow yields for the majors are highly attractive although longer term valuations (which assume a reversion in commodity prices to long term trend levels) are more challenged.

We see the best opportunities in a number of structural growth and infrastructure stocks which have been left behind as the market focuses on near-term cyclical trends.

Stocks in Focus

After rebounding strongly in April after a sell-off in the previous month, Fisher & Paykel Healthcare underperformed the broader market despite reporting an outstanding profit result. Demand for the company's products boomed last year as hospitals around the world purchased its respiratory humidification products to treat COVID patients.

Management did not provide profit guidance for FY 22 due to uncertainty around near term demand for its hardware and consumables, and this has seen profit estimates revised lower. We also expect profit to decline this year but believe there has been a structural improvement in prospects for the business as the installed base of its hardware has grown more than 50% over the last 12 months, which should drive accelerating growth in sales of consumables over the next few years. The medium term profit outlook looks more attractive to us than pre pandemic.

The Warakirri Ethical Australian Equities and Warakirri Concentrated Australian Equities Funds *are long only, low turnover, concentrated and benchmark unaware. As such they will typically hold no more than 40 stocks. These stocks will come from a concentrated Approved List of about 60 stocks based on Northcape's research of selected stocks comprising of resilient businesses with clear opportunities for growth.*

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