December 2022

Australian Equities Market Outlook 2023

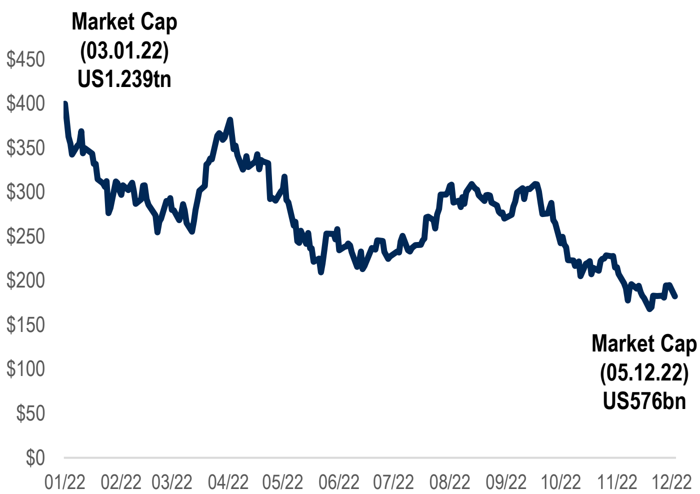
As conditions normalise and evolve post Covid, we are focused on isolating structural trends from cyclical conditions. A general de-rating of high-growth stocks in 2022 has created a wider set of opportunities for investors like us who care about both growth and valuation. We expect to continue to add high quality companies to the portfolio in 2023. Here we share our perspective on what lies ahead for Australian Equities in 2023.

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

Recap on key themes of 2022

Back in January inflation was still low and the cash rate was 0.1%, contributing to high asset prices generally. Some pockets of excess were evident in markets, for example in the US the NASDAQ index was 65% above its pre-covid high, the market cap of Tesla was over US$1trillion - more than every other car maker in the world added together **(see Exhibit 1),** and in the crypto space digital images of cartoon monkeys changed hands for $4m apiece.

Exhibit 1: Tesla share price (USD) – Jan. '22 to 5 Dec. '22



Source: NASDAQ. Chart prepared by Warakirri Asset Management.

Energy prices were rising as demand recovered post-pandemic and supply struggled to keep up. Notably, this trend was underway before the war in Ukraine, which sent prices higher again. The prices of most commodities started the year well above their historical averages, including iron ore, copper and gold. This group fell during the year while lithium and coal prices saw record increases.

The good news in 2022 was that Covid faded as an issue during the year. Australia had over 10 million recorded infections this year but fortunately with a low fatality rate of 0.15% (and much lower again for people who were vaccinated and under 80).

At times the sheer number of people isolating created some disruption for business, but government restrictions generally didn't come back and air travel ramped up over the course of the year.

A flat year with big divergences between sectors

These conditions set the scene for markets in 2022. The Australian market was roughly flat for the year at the time of writing but with big divergences between sectors. Resources were up 23%, led by lithium, coal and oil and gas producers. The major miners also rallied despite lower prices for their main commodities, boosted by a lower AUD and strong cash flows. Financials also outperformed, boosted by higher interest rates.

At the other end of the scale, the worst performer was the IT sector which was down 30%, mainly reflecting the impact of higher interest rates on some of the lofty valuations in that sector.

Higher interest rates also affected property prices and housing activity, leading to underperformance of REITs and building materials. Stocks that had benefitted from covid generally underperformed as life returned to normal, including retailers and healthcare. The rapid rebound in travel boosted QAN as limited airline capacity led to much higher ticket prices.

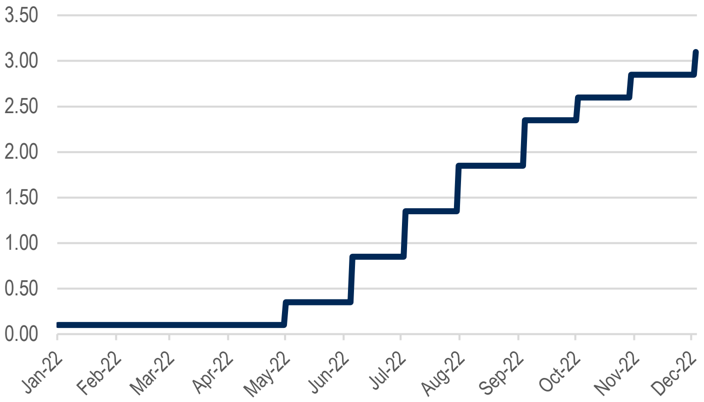
Will interest rates continue their upward march in 2023?

As the year draws to a close, the cash rate is at 3.1% (**see Exhibit 2**) and futures markets are pricing in further increases to around 4% by late 2023. Whether this will be enough to bring down inflation is very hard to predict - witness the RBA's own forecast last year that rates would stay near zero until 2024.

One scenario we suspect the market is under-appreciating is the prospect of a slowdown that causes rates to fall again.

Retail sales are extremely strong today, but there is a lag between increases to the cash rate and the impact on households so additional pressure on household budgets is already locked in. In the scenario where rates fall, we would expect a reversal of some of this year's moves and outperformance by quality defensives and stocks with structural growth.

Exhibit 2: RBA marches on – Official Cash Rate (%)



Source: RBA

Australian economy to grow moderately

Our central scenario is that the economy continues to grow moderately next year, with a continued reallocation of spending away from goods towards services including travel, with some reduction in discretionary purchases due to higher mortgage repayments and energy prices. We note that some of the heat appears to be coming out of the employment market already and some businesses are now seeing declines in key input costs from elevated levels e.g. lumber.

Current market conditions are challenging for investors. Asset prices had benefitted from a long tailwind of falling interest rates that has largely come to an end, bringing unstuck investment strategies that were heavily biased to growth. Companies are also facing a more difficult operating environment with uncertain demand and higher input costs. This is most evident among the gold miners, who are dealing with lower prices for gold and copper at the same time as their costs are rising rapidly.

Structural growth trends rather than cyclical an advantage

We think the companies that will do well in this environment are those with a strong competitive advantage and structural growth. These companies tend to have higher operating margins which can help insulate against rising input costs, along with an ability to pass higher costs on to customers.

Revenue growth that is driven by a structural trend rather than cyclical factors is also an advantage. Fortunately, the valuations of many companies with these characteristics have de-rated over the last 12 months, creating attractive opportunities for patient investors.

Mixed earnings outlook

The near-term earnings outlook is mixed as always. Commodity producers should continue to generate strong earnings and cash flow. Banks are expecting large increases in profit next year as their net interest margins expand, however we expect this profit growth will not be sustained in 2024.

The ongoing recovery from Covid should benefit companies that were affected by lockdowns in FY22, including QAN, CSL and IEL. Insurers should see good profit growth due to higher premiums and higher investment income, while some more cyclical businesses could experience a downturn including those exposed to housing, retail and employment.

In conclusion – Quality, value opportunities abound in 2023

As conditions normalise post Covid and continue to evolve, we are focused on isolating structural trends from cyclical conditions. While many market participants focus on predicting short term changes in conditions and sentiment, we are looking for structural winners. Occasions when the market is focused on a short term issue at a high quality business create the most exciting opportunities for us.

A general de-rating of high-growth stocks in 2022 has created a wider set of opportunities for investors like us who care about both growth and valuation.

We expect to continue to add high quality companies to the portfolio over the year ahead.

For more information, please contact us on 1300 927 254 or visit warakirri.com.au