NORTHCAPE CAPITAL

Warakirri ASSET MANAGEMENT

Australian Equities: Opportunities in a Volatile Market

Our specialist Australian Equities investment partner, Northcape Capital, recently spent two weeks in the U.S attending conferences on Technology, Media, Telecommunications and Retail as well as meeting with a broad range of companies and industry bodies. A summary of their views from the trip are provided below.

October 2023

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

Portfolio Insights – US Research Trip

Despite a slowing economy, US consumers are holding up better than expected, supported by strong employment conditions, the use of excess savings and the positive wealth effects of house prices and the share market. Whilst in aggregate this has supported consumption, it masks a huge divergence in spending patterns between socio economic groups with the less affluent struggling to make ends meet.

Consensus opinion appeared to be shifting towards a soft landing and away from an outright recession. While it was debated that lags in the system may be delaying the impacts of the Fed's significant monetary tightening, the consistent release of better- than-expected economic data was the rationale for this. Even in manufacturing where conditions were weak, profitability is better than anticipated as supply chain costs ease, input costs taper, and pricing remains elevated.

Given persistent inflationary pressures, it was surprising that views on interest rates were also milder than expected. Consensus was for one further increase in cash rates, with long-term rates easing by mid-2024. Forecasts for prices are centred on future disinflation rather than deflation.

Debt markets remain functional, despite earlier concerns over the US banking system due to commercial real estate exposures and the insolvency of Silicon Valley Bank. Generally, commercial banking balance sheets have few doubtful debt exposures, and higher interest rates are driving enthusiasm to lend.

The retail outlook was cautiously optimistic, with Black Friday/Cyber Monday and Holiday sales expected to be decent, despite cycling strong numbers. Inventory levels have largely normalised, and pricing is still marginally positive offsetting some of the rise in labour expenses.

For tech companies, it was unsurprising that the focus was on Generative AI. No doubt we will see serious spend in this arena. The first requirement will be to organise data into the correct buckets (a human task) as without this building block the output from deploying AI software will be of little use.

In the shorter-term the payback will be focused on cost reduction by eliminating human manual tasks and less efficient computing. In the future, revenue opportunities will arise as products and services are generated and deployed more effectively.

The main risk to the economy in our view is labour market deterioration. It should come as little surprise that the strength of current employment market releases in the US has led to a sharp sell-off in bond markets and subsequent falls in equity markets. It is likely that until the economic picture becomes clearer, the market will continue to be volatile as additional data points emerge.

Ratio of job openings to hires, all private sector jobs

With an understanding of the economic environment, the second part of the trip was spent meeting with the offshore operations of ASX listed companies. We met with a broad range of companies including portfolio companies Fisher & Paykel Healthcare, Macquarie Group, Xero, Qantas and James Hardie, as well recent addition to the Approved List Carsales.com. These meetings were the highlight of our research trip, and some read throughs are summarised in the section below.

For all portfolio companies we remain constructive on the investment case and outlook, and have retained our portfolio positions, following the recent offshore meetings.

Fisher & Paykel (FPH) was the one of the most interesting meetings of the trip. We came away with a thorough understanding of growth opportunities in US market and are more positive on the long-term outlook post this. FPH is a current top 10 active position in the portfolio, and we believe is well positioned to benefit from the long-term outlook.

In capital markets, there are signs of recovery post the US summer holidays. Some line of sight on interest rate stability is providing a catalyst for pent up transaction demand.

The recent successful IPO of chip design company ARM Holdings was seen as a bellwether for improving sentiment. Both **ASX Limited (ASX)** and **Macquarie Group (MQG)** are positively leveraged to a global upturn in capital markets activity, and improving conditions in the US is a potential positive catalyst for these two portfolio companies.

We had a meeting with **James Hardie (JHX)**, as well as various housing related meetings and came away with a positive view of the current environment and outlook for the company. Over the last 18 months U.S. housing market forecasts have been volatile, influenced by sensational media reports. Initially predicted to decrease by 20% in 2023, new housing starts may finish the year slightly higher.

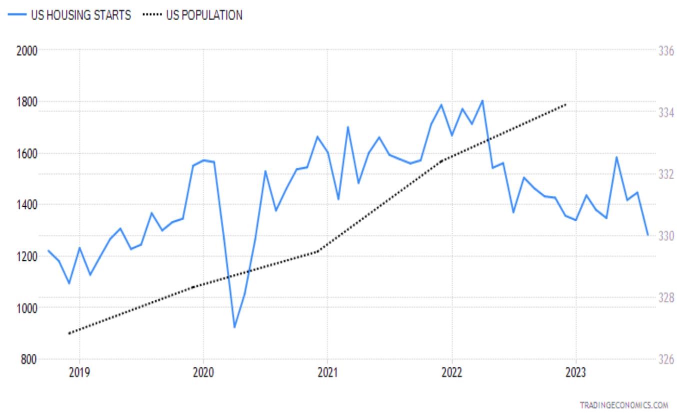
Dire earnings estimates proved equally inaccurate yet building related share prices had to run the gauntlet of negativity at times. For James Hardie the market significantly increased the large earnings declines it had factored in. We used this period and associated share price declines to increase the portfolio weighting. As it transpired, Hardies earnings only declined 3% and estimates for the current year raised and the stock has performed strongly.

Large public home builders, after their near-death experience of the GFC, now run materially better businesses, generating higher sustainable returns and margins which they have used in part to offer mortgage relief to home buyers. In turn they continue to take large amounts of market share. This outcome coupled with the growth in detached housing starts plays to James Hardie's strengths in the marketplace for new construction as they predominantly supply the large homebuilders.

On the U.S. Repair & Remodel outlook, there are short-term headwinds but feedback across the market suggests activity has not been as weak as forecast. We believe growth will remain tepid for a while but offsets from lower input costs and recent price increases will assist the JHX in delivering higher earnings for the year ended March 2024. In our view the company's valuation already reflects a general nervousness with respect to US mortgage rates which provides opportunity, as we look at the strong medium-term fundamentals ahead.

In the US, the sheer undersupply of housing (and rental accommodation) combined with exiting pent-up demand, the degree of aged housing stock in need of repair & remodel and the new underlying demand from Millennial's who have reached the prime homebuying age has created pre-conditions for strong housing related markets for at least the back half of the decade.

Supply Shortages in US Housing Market



Last year showed that when rates stabilise demand recovers quickly. Our discussions with homebuilders, contractors for renovation, big box home improvement retailers and wholesale distributors all are talking to this outcome.

We see this period as highly attractive for James Hardie's earnings profile when compared to the market and coupled with an attractive current valuation. The possibility of a positive re-rating should drive outperformance. We maintain a solid overweight position and would look to use any short-term volatility to add to the position.

Summary

In summary, in times of market uncertainty, we think reliable and stable earnings will be rewarded by the market. Our portfolio remains steadfastly focused on a diverse and largely uncorrelated range of companies that exhibit high quality attributes, including high operating margins, pricing power and sustained high returns on capital.

These attributes were reaffirmed on our recent research trip. While share price movements over the quarter have been volatile, we are comforted by indications of good underlying operating performance trends from our portfolio companies which should set us up to do well over year ahead. We have taken advantage of market volatility to build positions in companies that have been hit by negative short-term sentiment, especially where we have longer term conviction on earnings growth and cashflow.

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