Market and stock commentary

What are your thoughts on the US Bond market and yield curve inversion?

MATTHEW HAUPT: We closely monitor bond markets as part of our investment process, as it not only informs the cost of capital and therefore valuations, but is a leading indicator for inflation, growth and the overall health of the economy. The US bond market has been particularly volatile this year, with yields surging in February before the regional banking crisis sell off in March. Since then yields have been range bound, reacting to economic data points as the market awaits clarity on the path forward for cash rates and the state of the real economy.

Yield curve inversion occurs when short duration treasury bonds are trading at higher yields than their longer duration counterparts, and is often associated with being a recession indicator. Yield curves in the US have been inverted since mid-2021, reaching lows of greater than 100 basis points (2year/10year) in March 2023 when 2 year yields surged to over 5%, and has since improved to around -60 basis points. With economic growth set to weaken over the coming months, long duration bond yields are likely to remain under pressure. Yet monetary authorities worldwide are reluctant to ease policy, which should keep shorter duration bond yields elevated. These two dynamics together suggest yield curve inversion will remain over the near term. However many scenarios are possible and the environment can change quickly; the economy may soften faster than expectations forcing policymakers to step in, while if the economy and inflation proves more resilient than expected, yields across all durations may shift higher. We watch all fixed income indicators closely to inform how we deploy capital across the ASX200.

Matt, you've spoken about Dexus before and the share price soared after that. What are your thoughts now?

MATTHEW HAUPT: Dexus remains a top 20 holding in WAM Leaders. It is still trading at a greater than 30% discount to its net tangible assets, and ascribes no value to its $45 billion funds management business. While undeniably some degree of the work from home thematic is permanent, the irreplaceable locations and quality of Dexus' portfolio, their occupancy rates, and long lease expiries stand them in good stead. Their balance sheet is strong and management are exceptional asset allocators. An economic slowdown presents challenges for the whole market, and Dexus is not immune, but we are confident in the medium term opportunity given how little is priced into the current share price.

Do you have exposure in the agriculture sector in your funds?

OSCAR OBERG: Agriculture has had an amazing last two or three years, basically as soon as coronavirus occurred and the consistent rain on the east coast of Australia begun. A couple of years ago we held Elders and Graincorp in the investment portfolio. We sold those businesses about a year ago because we believed conditions couldn't get any better. Our biggest holding now in WAM Capital is Select Harvest and it is about 1.5% of the investment portfolio. We own about 5.7% of the company. We like it because it's probably the only soft commodity company globally that hasn't gone up over this period. It's actually the almond price which is at record lows. It's currently trading

at a discount to its net tangible assets. We are happy to wait for an average almond price and earnings will come through.

DANIA ZINUROVA: We have agriculture in WAM Alternative Assets. It is quite concentrated exposure to one specific asset, American citrus, but as you know Australian citrus has been in high demand so probably still a few years until it matures. I'm looking at this as a high potential investment within the investment portfolio. Agriculture is about 10% of the investment portfolio and it is quite an important asset class for us.

You mentioned about Global Data Centres. What has happened there?

GEOFF WILSON: We hold Global Data Centres in WAM Strategic Value. There has been an announcement by the Board that said a listed structure isn't a perfect structure for them, so they've restructured all the management agreements and performance fees.

There seems a bit of a wind back on globalisation in terms of going back to domestic production, the obvious problems that have come up in terms of threats to supply chains etc. And also the longer term slower changes, and the other is the obvious acute type of risks like for example Taiwan.

CATRIONA BURNS: We are constantly talking to companies that we own, competitors, suppliers etc. We own a variety of companies that manufacture in many places around the world. The amount of discussion around deglobalisation is significant right now. When companies are setting up new facilities or adding incremental capacity, we frequently hear that they are wanting to move supply closer to the end markets that they are serving, whether that's Mexico to supply the US, countries across eastern Europe for Europe or South East Asian countries for local markets across Asia. The trade wars and the pandemic highlighted how reliant global supply chains were on China and there is a strong desire to reduce this reliance given geopolitical concerns and because of the additional resilience added to your business from having multiple supply points. Nick and I were recently in Japan and met with the makeup and skincare company, Shisheido, for example. They have manufacturing supply in China already but need to add additional capacity. They have decided they will do this in other parts of South East Asia and domestically in Japan, despite recognizing that there is still an enormous market opportunity in China. Changing supply chains will be a slow process. In certain products, unwinding the reliance on China is near impossible near term given the closure of domestic supply and the share of global production that they have. For example in Australia, the automotive industry has closed and that won't be coming back.

GEOFF WILSON: And just on that there was a great article in the Financial Review just recently. Jonathan Shapiro wrote it and he was basically saying how that cost is probably going to add what is it 1% to inflation globally per annum or consistently.

CATRIONA BURNS: Yes the deglobalisation trend is inflationary as it adds additional cost. China has been such a low-cost supply alternative for many products and components. There are significant economies of scale achieved as you increase production, drive efficiencies and spread your costs over a larger number of goods. With deglobalisation, as companies move to having multiple factories closer to end markets, this comes with additional costs, but has a risk mitigation and security of supply benefit.

On the geopolitical front, concern around an escalation of China and Taiwan tensions is at the back of company's minds and plays into this move to spread their supply chains more.

Deglobalisation has not progressed far enough yet to mitigate this. Given how much reliance there remains on China and Taiwan for many components, including semiconductors, any escalation would still be very disruptive to global supply chains.

What is your position on materials and in particular iron ore, gold, copper and oil?

MATTHEW HAUPT: On iron ore we traded those companies down recently. Because, again this is part of the process, we got information that a lot of the blast furnaces were going into maintenance for a period. And this is where it actually doesn't change the value of the companies but in the eyes of the stock market when they see the spot iron ore price decline people sell them. So we that would be the case and thankfully we have reduced them a little bit. But like longer term we're actually quite constructive. So again it just goes back to the process, new information you adjust the portfolio. But long term quite constructive because, I mean property is the base of wealth in China. There was political unrest. They went through a five year programme to try and get the speculation out of property. We're about two and a half years through that now. So generally around the two year mark they start to relax policy and that's exactly what they've done now. So iron ore still quite constructive on that. I mean the big caveat is global growth but China's like 75-80% of domestic iron for us so it's really a China story. On the other names, like oil, probably not for our benefit we're always oil bulls. And it's really, again back to geopolitics, like that's a constant geopolitical battle we're always facing with oil because as you know OPEC Plus the group which controls output decisions have actually been pulling back output. So, despite the economic slowdown, the actual supply side doesn't look too bad. So oil we like and we like Santos in that space because Santos is ridiculously cheap and about 5% of the investment portfolio. They've had a few hiccups along the way and the market has sort of discounted that. But we think they'll work those issues out of the next three to six months. So we see a re-rating in Santos. You know irrespective of the oil price we think it could perform. On the other companies like Iluka we like. Again back to geopolitical risks the world is re-arming off the back of Ukraine. So Iluka is involved in obviously mineral sands for like paints and the like titanium dioxide, but they have rare earths project now which is going to get a lot of international interest. So the government has given I think it's over a billion dollars non-recourse loan which is unheard of in Australia. So they've got all the stockpile there. They've got funding now. It's going to take a few years for them to build this but the world is re-arming so from an investment point of view the only way we can capitalise in Australia is now predominantly through Iluka. You know we like South32, good mix of copper, manganese and some coal which they've been reducing coal exposure. But again copper's a bellwether for industrial production. Industrial production has been slowing. Global PMI actually ticked up over the last few months but the recent survey data looks really bad so maybe the PMI's rollover again. We are not constructive on the outlook for copper. They're probably the main ones. Like copper, unfortunately we can't get it through Oz Minerals anymore that was our go to. Now BHP have got Oz Minerals well in the process of getting Oz Minerals. So if we do like copper we play it indirectly through Newcrest, which is obviously a gold company under takeover as well, but they have like 20% of their earnings through copper. But

obviously the way you play it now is through BHP. When you think the world is going to debase the currency, the fair currency, a lot of money goes into gold. So I'd say it was under owned gold. Now sort of the ownership of gold is fairly neutral. But I would have thought gold looks pretty good over the next twelve months, if we do go into this economic slowdown. The other scenario is the economy is not as bad as people think, then gold will get sold off heavily. Because it's really a safe haven asset. A place to park money without getting a devaluation from expanding the monetary base. So they are the real signals for gold you've got to watch out for. The way we play it is, again we're losing all these great companies, so Newcrest is probably going to go unfortunately, so Northern Star Resources for us is the next best. And then you go down really low unfortunately. Evolution is having all sorts of issues and is capital starved and then we just don't go down the quality curve post that because we like having liquid positions we can move.

There's a lot of talk in the streets about reindustrialising the home countries, especially Australia. This seems to be asked for Australia, but the people you've been talking to obviously it would be very high on the agenda of thinking about this stuff if it's feasible. Do any of you people see any significant likelihood that Australia will start to re-industrialise to any extent and re-capture or claw back any of its industrial capacity?

MATTHEW HAUPT: 100% no. Just because, corporations are there to maximise profit, if you did it it would be counterproductive for companies and also for the GDP of Australia. So I can't see an economical reason. For security reasons- data- there is a movement for that but it's low cost. I don't want to be presumptuous but I don't think there'll be massive CapEx on the industrial side in Australia for the foreseeable future. So on manufacturing I'd highly doubt it. Companies like CSL has built a big new building down in Melbourne but I just can't see it happening at our end. I'm not sure if Oscar you agree?

OSCAR OBERG: No I'm thinking oil and gas. On new projects for oil and gas in the east coast the government is just doing everything that they can to make it difficult so until that frees up I can't see it.

MATTHEW HAUPT: No exactly. More taxes you know PRRT potential changes there. No climate policy. Gas policy is in shambles. It's hard to see any major CapEx or re-industrialisation of the Australian economy at the moment.

How much do macroeconomic factors impact your investments?

OSCAR OBERG: We are stock pickers identifying undervalued growth companies that have a catalyst to re-rate over time. We take macroeconomic factors into consideration however these factors don't stop us from finding attractive companies.

Small-caps are risky stocks but they should also have higher growth prospects to compensate for the risks. Concerns around a recession have impacted this area of the market and 50% of small cap companies are exposed to retail, housing, automotive and property for example, and we have seen a sell-off here.

I'm seeking your input on two areas. One is the climate change green energy area where global business was already more in favour than Australian business but in the recent past Australian business across the board seems to be more on board, so in that area. And second is the artificial intelligence (AI), which is also growing. Now in both of these areas as you know there are some very established players for a long time and there are a lot of newcomers which can fall into the speculative area. What are your thoughts in terms of investment in these two areas?MATTHEW HAUPT: I can do a broad climate change. Fortunately in the large cap space the companies take care of a lot of that for us. They're all moving in a direction so for us we've just got to make sure we can take advantage of it. Domestically everyone's crying out for some policy certainty. We speak to AGL and Origin they say "we don't know what the government wants, we don't have a framework, and we can't invest money", so everyone's screaming out for some policy certainty. I mean that's in a very specific area but I think globally Australia has been left behind and I think it's really been we haven't had bipartisan policy support so it's still up in the air. So the companies we speak to just say "hey give us some guidelines and then we'll adhere to them" but we just don't have any guidelines.

OSCAR OBERG: On the small cap side of things as well, very small companies obviously, but you do see some great opportunities for companies that you see them and think to yourself this has got an ESG or social governance angle to it and you know that it will get a premium valuation. So we've got a couple of companies. So Mermaid Marine is a great example. Been around for a long time, was 100% in the oil and gas industry and all of a sudden it started to do offshore wind projects and it's now 30% of their revenue. So you look at a company like that and you think once the market works that out it'll have a premium valuation associated with it.

CATRIONA BURNS: Firstly, from the climate change perspective, an example of a business that we hold in WAM Global that will be a beneficiary of the trends underway there is Quanta Services. They are a US-listed business and the largest contractor involved in upgrading and modernizing the electrical transmission grid across the US. The grid in the US has been underinvested in for years and now we have the additional complications of trying to add renewable power into the system and also add electric vehicles into the vehicle fleet. There are enormous upgrades required to enable this. The US has announced significant legislative support for these investments, such as the Inflation Reduction Act (IRA). This will provide large amounts of funding for bringing additional renewables into the energy supply in the US. We see this backdrop as extremely exciting for Quanta Services in coming years.

Regarding Artificial Intelligence (AI), I was just in San Francisco for a Morgan Stanley Technology, Media and Telecom conference. To highlight how front and centre this is in the mindsets of companies and investors right now, every one of the hundreds of companies that presented was asked what is the impact of AI, how do you see it impacting your business and how are you using it. Sam Altman, the CEO of Open AI which created Chat GPT presented. He made it clear that they have partnered with Microsoft because they thought they were the most aligned, and responsible partner to do this with. He openly admitted that the models still need work and so do the regulations around usage. When you use Chat GPT, for example, the results aren't always factually correct and can be influenced by what is fed into the model beforehand. So overall, we think AI has exciting potential applications but there is some work to be done still in areas such as improving

outputs and security. We have a number of holdings in the WAM Global portfolio, including SAP, Intuit and Adobe, that are utilizing AI in its infancy and which we think will be beneficiaries of the benefits that it brings in terms of efficiency and so forth.

DANIA ZINUROVA: It was only on the climate change that there are a lot of opportunities within the alternatives space. Like renewable energy infrastructure within private equity space as well. The challenge within listed equities is that, Oscar is right and Matt in saying that at the moment there are no established standards. How do you measure it across all the industries? So within private capital space you'll probably see more activities on that front driven by both investors but also by industry companies.

OSCAR OBERG: I was just about to say we're starting to see in the micro-cap space quite a lot these AI companies so I can envisage it becoming the next Buy Now Pay Later. So anyway watch this space.