MARTIN CURRIE

FRANKLIN TEMPLETON

Quarterly Commentary – Martin Currie Equity Income Fund

Q3 2021 Quarterly Commentary

Quarter Ending: 30 September 2021

Market Commentary[1]

The Australian equity market rose 1.7% in the September quarter (as measured by the S&P/ASX 200 Accumulation Index), with September's negative return the first after 11 sequential months of positive returns.

At the sector level, energy was the best performer as shortages in multiple regional markets drove up gas, coal and oil prices. Non-bank financials were also strong. Metals & mining was the weakest sector due to falling iron ore prices, which after being well above historical levels for some time, have halved over the last two months. This fall is in response to China's slowing growth, with concerns around the country's environmental policy reducing steel production and the collapse of Chinese property giant, Evergrande.

Market Drivers During the Quarter

While August's Australian company reporting season, spread of the COVID-19 Delta variant globally, local lockdowns and the subsequent reopening trade were dominant themes throughout the quarter, it was events in September which had the most impact on the market.

During reporting season, we saw very strong reported results versus consensus expectations, strong cash flows and balance sheets driven by Government stimulus, and dividends per share upgrades. There was also a significant number of capital management, merger & acquisitions and capex spend announcements. For our full Australian reporting season wrap see here.

The US purchasing managers index (PMI), a key indicator of the country's economic health, held at a very high level but is slowing, whereas in China it noticeably slowed. World earnings were up 5.3% for the quarter reflecting the recovery, whereas in Australia it was only up 2.1%, primarily driven by the fall in iron ore prices. There was a massive divergence between commodities, with oil and aluminium up and iron ore down. China's restrictions on energy and attempts to green their economy, which is resulting in ESG inflation, and property concerns caused by the collapse of Evergrande, are largely responsible for this divergence. For example, steel production cuts in China hurt iron ore producers but restrictions on Chinese aluminium producers cause global supply shortages and lift the Western world's Aluminium and Alumina prices.

Over the quarter, bonds yields rose, primarily in September, influenced by the US Federal Reserve looking to taper its quantitative easing program and inflation concerns. Within this environment, the market's approach was generally risk-off and over the quarter mid-caps and growth-style strategies led. On the flip side, income ETFs were the worst performers in correlation with large dividend paying iron ore miners, given the high concentration high-yielding strategies hold in the iron ore miners. We saw a late swing to value-style names in September and we note that value spreads remain elevated.

Performance

The Martin Currie Equity Income Fund (Equity Income Fund) was up 3.2%[2] (net of fees) in the third quarter. Over the last 12 months, the Fund returned 30.7%[3] (net of fees).

At the sector level, utilities and non-bank financials were the largest positive contributors, while consumer discretionary and metals & mining detracted.

At the stock level, Ausnet Services, Alumina and Medibank Private were the largest positive contributors, while BHP Group, AGL Energy and Platinum Asset Management were the biggest detractors.

Main Drivers of Absolute Returns

Positive

Energy company **Ausnet Services'** share price surged on the back of competing takeover bids from Brookfield Asset Management and APA Group, with APA lodging a complaint with the Takeovers Panel regarding Brookfield's exclusive due diligence. We note that Ausnet can still engage with and do deals with other potential bidders, who can make subsequent offers after eight weeks.

Alumina and bauxite producer **Alumina** was strong throughout the period, releasing a better-than-expected 1H21 result in August, which included a higher dividend due to increased cash flow. Alumina is benefiting from underlying commodity price strength due to numerous supply disruptions, including a port outage in Brazil, a fire at a plant in Jamaica, China curbing its alumina production in response to Government energy restrictions, and political unrest in Guinea which supplies China with bauxite, the ore from which Alumina is made.

Medibank Private was another top contributor, with the health insurance company releasing a strong FY21 result in late August. Medibank is showing the benefits of its conservatism in provisioning and a focus on the customer by delivering record profits, while also giving the company a good platform for expansion options in the broader healthcare space.

Negative

BHP Group is being negatively impacted by the fall in iron ore prices, as detailed above, as well as the announcement to dissolve the Dual Listed Company (DLC) structure.

Electricity and gas retailer **AGL Energy** experienced share price weakness due to a soft trading update from peer Origin Energy early in the quarter and lack of detailed financial information over the proposed split into two business - carbon neutral, 'AGL Australia', and carbon intensive, 'Accel Energy'. We note that AGL did release in line FY21 result, although its FY22 earnings guidance came in below expectations, which management attributed to low electricity prices. We note the demerger appears on track.

Platinum Asset Management was down as the active investment manager has been experiencing weaker flows.

[1] Source: Martin Currie
[2] As at 30 September 2021. Source: Franklin Templeton. Past performance is not a guide to futurereturns.
[3] As at 30 September 2021. Source: Franklin Templeton. Past performance is not a guide to future returns.
[4] As at 30 September 2021 Source: FactSet, Martin Currie Australia

New Views Formed & Trading Activity During the Quarter

We trimmed the position in pipeline owner **APA Group**, given some uncertainties around the contested takeover bid for Ausnet Services and protracted due diligence period granted to the opposing bidder, and cycled the proceeds into initiating a position in **Atlas Arteria**. The global toll road operator is a beneficiary of economies reopening post COVID-19. The company's European toll roads are already seeing significant traffic and mobility improvement. Atlas Arteria has defensive characteristics, growing cashflow and a reasonable dividend yield which should grow in CY22.

We topped up the position in retail drinks and hospitality business **Endeavour Group** (which demerged from Woolworths Group in June), as it is a high-quality, defensive name which offers a steady dividend. Endeavour Group owns hotels and liquor outlets which are located in each state of Australia and now has the ability to grow as an independent company.

We increased the portfolio's exposure to **Scentre Group** given the retail REIT's strong pricing power, with its August results confirming that consumers are quickly returning to physical malls once COVID-19 restrictions ease. This is expected to lead to an improvement in retail leasing demand inside Australia's large retail REITs.

Prior to **Ausnet Services** receiving competing takeover bids, we topped up the portfolio's position. The energy company has an attractive valuation and upside from the strong multi-year growth in its asset base (and dividends) from major clean energy electrification projects connecting new renewable energy projects to the Australian networks.

We trimmed the position in **Wesfarmers**, taking profit after very strong share price performance and therefore lower expected income yield relative to the portfolio. The well managed conglomerate has been a beneficiary of ongoing lockdowns.

We exited the position in New Zealand utility **Genesis Energy**, taking profit after very strong share price performance and therefore lower expected income yield relative to the portfolio. Genesis has benefited from strong New Zealand electricity prices and the market's search for defensive yield.

Outlook

Global economic growth slowing on inflation and Delta headwinds:

- US PMI has held high but is slowing, with ongoing growth in activity likely to be at more moderate levels.
- China PMI has slowed, with the country's environmental policy having a divergent impact on global commodities.
- We have past the peak of governments and central bank quantitative easing.
- Bond markets are reacting to tapering and inflation concerns, resulting in falling bond prices and rising bond yields.
- As the recovery continues, global equity markets should further rotate out of Growth-style, toward Value-style companies and sectors.

Australian economy recovery from COVID-19 recession stalled by lockdowns:

- As the vaccine rollout progresses and we inevitably move out of lockdowns, the economy will continue its recovery.
- With the Government already spending billions on stimulus, there is capacity (on a debt to GDP basis) to spend more. With a looming federal election, we expect more stimulative policies.
- Australians have a very high savings ratio and that will be spent as they are released out of lockdown.
- Wages growth remains subdued, but a tightening labour market, particularly in sectors such as mining and construction, is likely to result in stronger wages growth in 2022.
- Infrastructure build is important moving forward, both large-scale infrastructure projects and residential communities, supported by the stimulus spend, demand and strong house prices.
- The work from home and regional Australia shift will continue to be important themes, with the battle for the household wallet ongoing.

Australian Equity market reaching record highs, but divergence remains across sectors and styles:

- The August 2021 reporting season saw results overall relatively sound, particularly dividends and balance sheet positions.
- Impact of the Delta variant spread, and lockdowns drove increased uncertainty for company forecasts.

- Consensus outlook for the market has sales growth looking consistent across each of the big sectors at around 5%, unlike the wide divergence across sectors over the last two years.
- Earnings growth for the ASX 200 companies is expected to be more than 10% for the next 12 months based on consensus forecasts.
- Continued profit margin expansion will be difficult given profit margins have already returned to pre-COVID-19 levels, with increased cost expenditure.
- Companies that have spent their stimulus windfalls well by investing in future growth, should be rewarded in the post-COVID-19 world, with Value style stocks being particularly well positioned to benefit.
- Despite the price of Australian shares being at record highs, there is divergence across sectors. The high prices being paid for Growth style stocks versus Value style stocks is still being driven by low rates and the weak local economy.
- Wide value spreads are a good predictor of stronger future Value style returns. As the Australia economy does reopen, we expect those value spreads will narrow and that will drive strong Value style performance.
- The yield gap between high-quality income payers and other income asset class options available today is still wide, supporting valuations of high-quality companies.
- Australian equities, that offer franked income, should be stronger performers as the market environment matures into the recovery. The income streams on our high-quality income focused strategies have recovered to their pre-COVID-19 levels and have a very strong outlook.

Portfolios across our range of Australian active equity strategies are based on MCA's valuation and risk discipline:

- MCA portfolios overall were on the positive side of reporting season fundamental results, validating our fundamental research and portfolio positioning.

Dividend Yields

While forward earnings expectations post August's reporting season were weaker for the market, it is really just a small blip compared to the significant progress that has been made since the depths of COVID-19 despair in 2020 and was driven by the three large iron ore miners.

Dividends continue to rebound on strong results, low payout ratio bases, and strong balance sheets. COVID-19 has been one of the biggest challenges to dividends we've had for the Australian market since the global financial crisis, with the market DPS falling about 34% over 2020.

However, forward expectations have now fully recovered to pre-COVID-19 levels, and the actual results are again coming in positively. The reason for this is that payout ratios are significantly lower than they were pre-COVID-19, and balance sheet net debt ratios relative to revenue and earnings are significantly improved.

This means that companies are in a very strong position to continue to raise their dividends going forward. One of the unusual aspects about aggregate dividends paid in the last financial year is just how much of an impact the iron ore miners have had on some income strategies that are highly concentrated in those names. In some index yield ETFs, the iron ore names make up 30% of the portfolio, so the recent sell-off in iron ore has had a significant impact. Whereas in our income portfolios we purposefully limit the concentration to any particular stock or sector with good portfolio diversification away from the concentrated composition of the index.

While the share market has recently passed all-time highs, the expected next twelve-month (NTM) income yield on the Equity Income portfolio is 6.4%* - high when compared to many other asset classes. This suggests the equity market remains undervalued when considering yield and income growth.

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[5] Source: Martin Currie

[6] Source: Martin Currie Australia, Factset; as at 30 September 2021. Next 12 Months (NTM) Income yield is calculated using the weighted average of broker consensus forecasts of each portfolio holding – because of this, the returns quoted are estimated figures and are therefore not guaranteed. Past Performance is not a guide to future returns.

IMPORTANT INFORMATION

Past Performance is not a guide to future returns.