Auscap Newsletter

APRIL 2024

AUSCAP ASSET MANAGEMENT LIMITED

Are There Implications From Lingering Inflationary Impulses?

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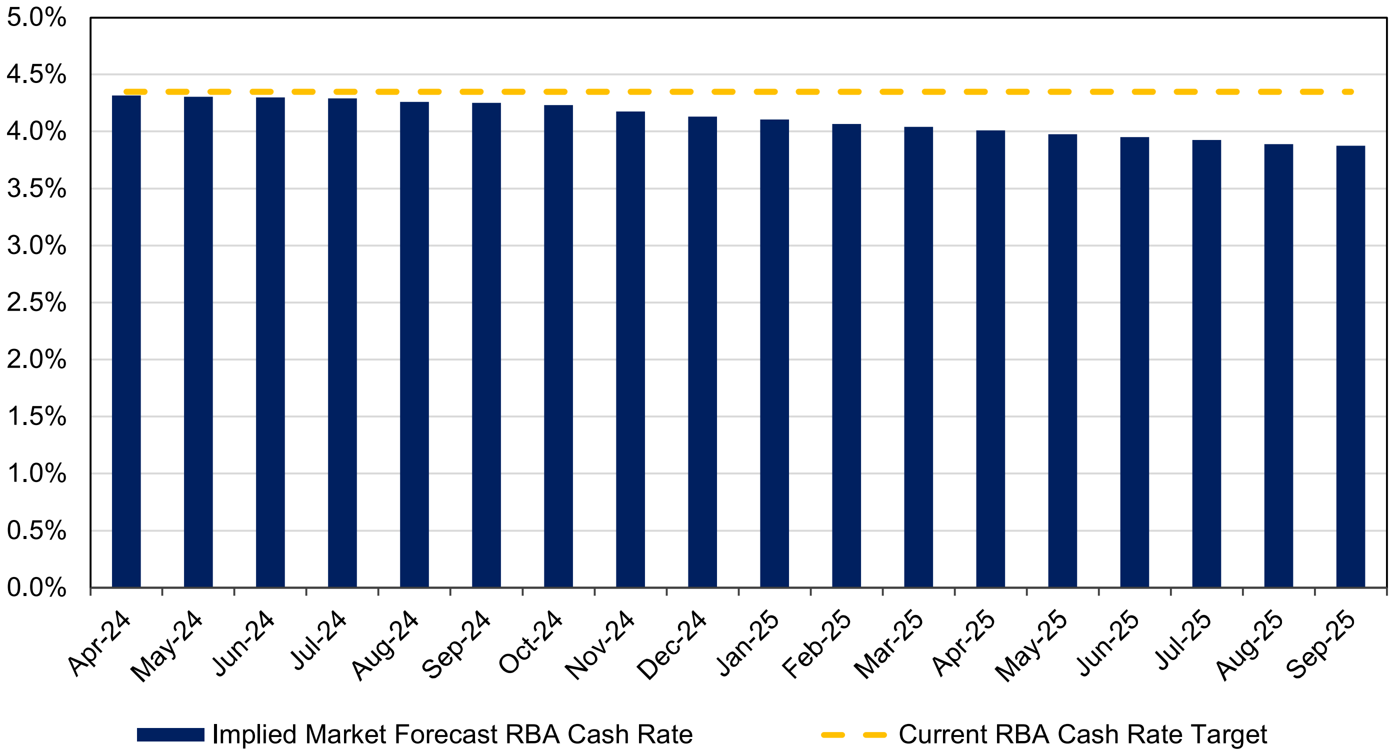
When analysing the outlook for equities, it can be useful to consider the assumptions financial markets appear to be pricing in. Historically we have found that opportunities and risks are most present when the market is pricing in bearish or bullish outcomes respectively that probabilistically are either not that likely to occur or will be brief in duration. Currently there appears to be a correlation between the rally in stocks and expectations that interest rates will fall. Even though these expectations have moderated in recent months, the bond market continues to suggest that rates will fall over the coming 18 months, as shown in the chart below. In this newsletter we try to objectively assess the data that might support this proposition.

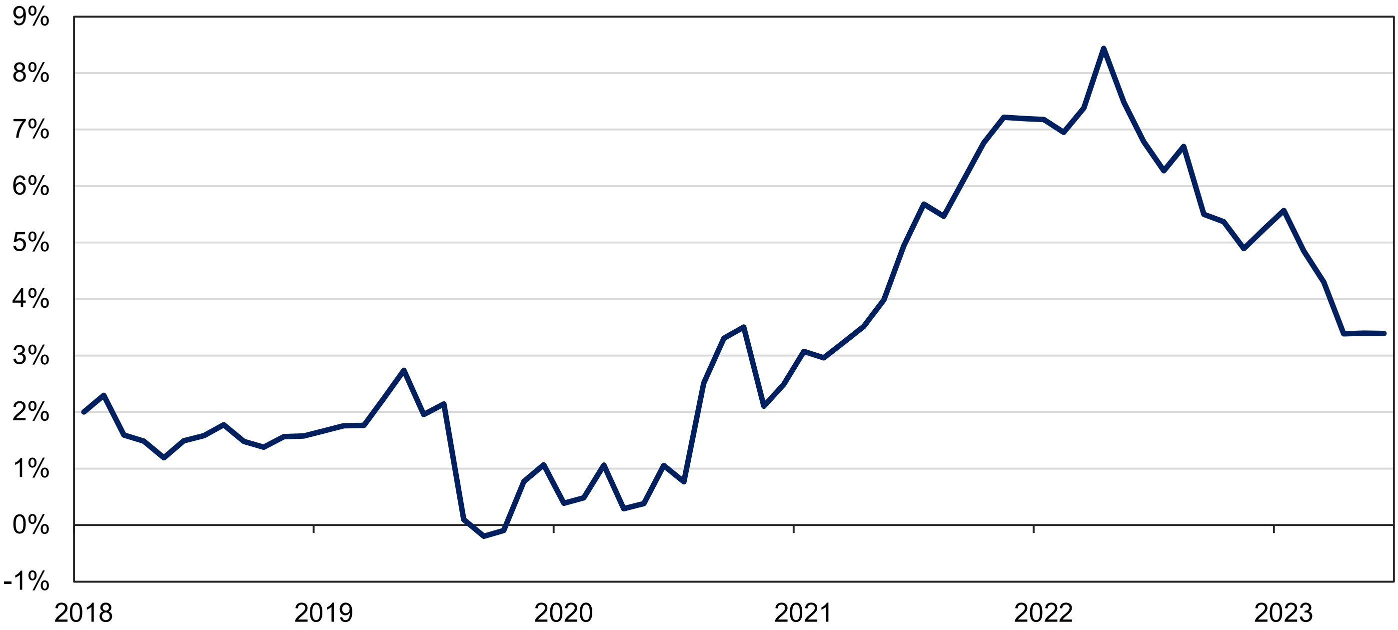
RBA Cash Rate - Current and Market Implied Forecast



Source: www.asx.com.au, Auscap

In December 2023 the Reserve Bank of Australia (RBA) and the Treasurer, Jim Chalmers, released an updated *Statement on the Conduct of Monetary Policy*. The statement, which records the common understanding of the RBA and the Government on key aspects of Australia's monetary and central banking policy framework, reiterated that consumer price inflation of 2-3% is an appropriate goal but noted that the RBA's monetary policy is directed at returning inflation to the target midpoint of 2.5%. Domestic inflation is currently running at 3.4%, which is above the top of the target band.

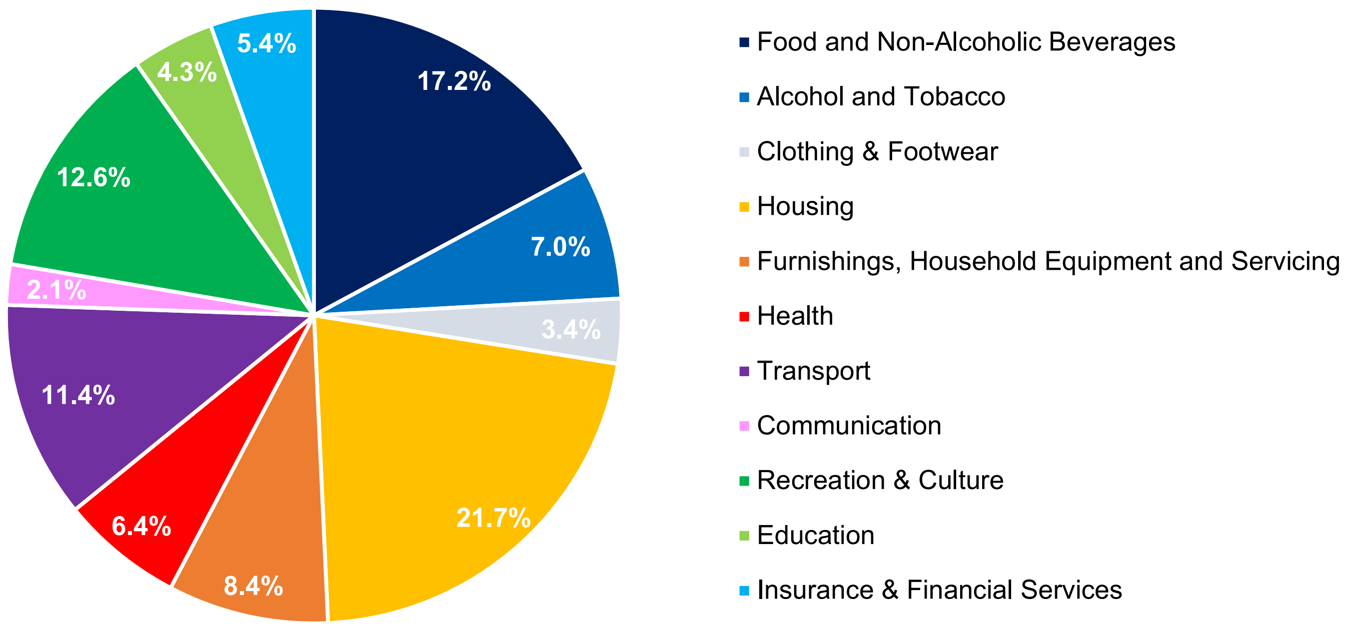
Australian Consumer Price Inflation



Source: Australian Bureau of Statistics, Auscap

The fact that it has now been at roughly this level for three months warrants closer examination. To do this, it is important to understand the components of Consumer Price Inflation (CPI) in Australia. The weightings of the various components are shown in the chart below.

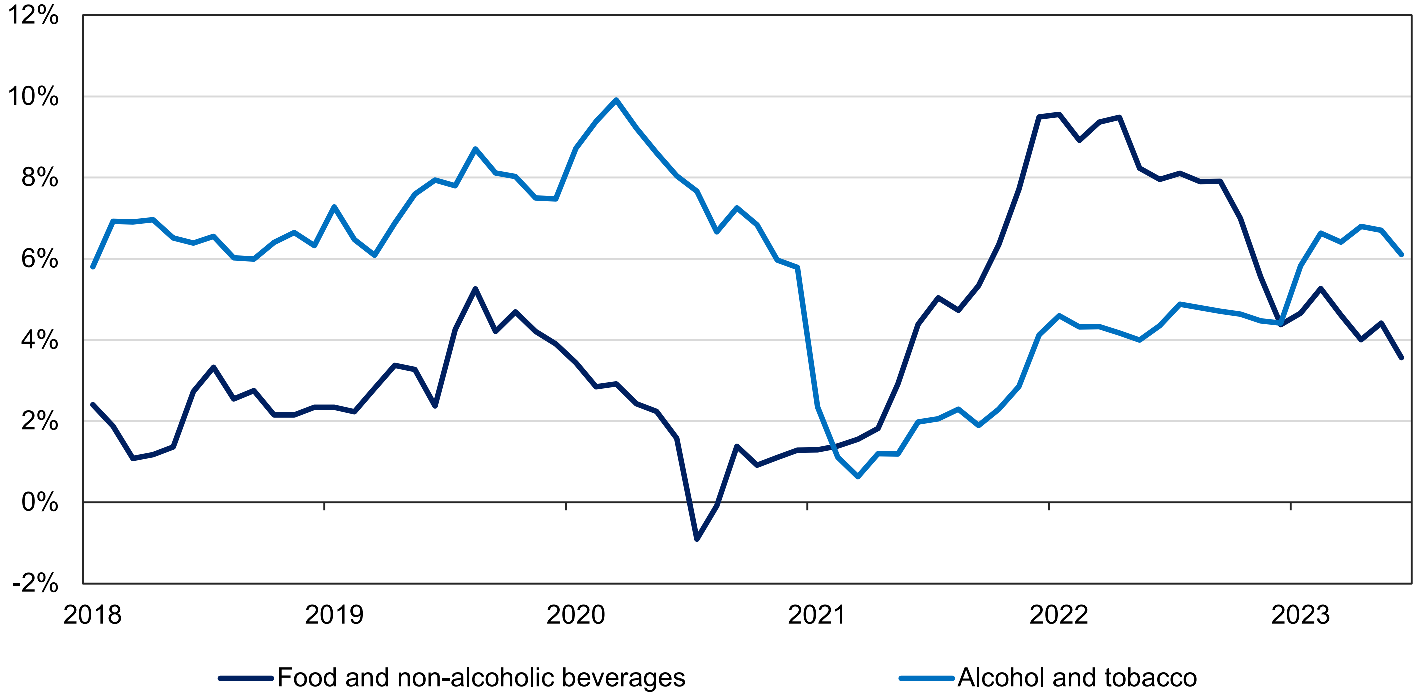
CPI Weights (Dec 2023)



Source: Australian Bureau of Statistics, Auscap

Currently some of the key components are experiencing quite different trends. Food, alcohol and tobacco are seeing declining inflation, albeit these categories are still well above the RBA's target band.

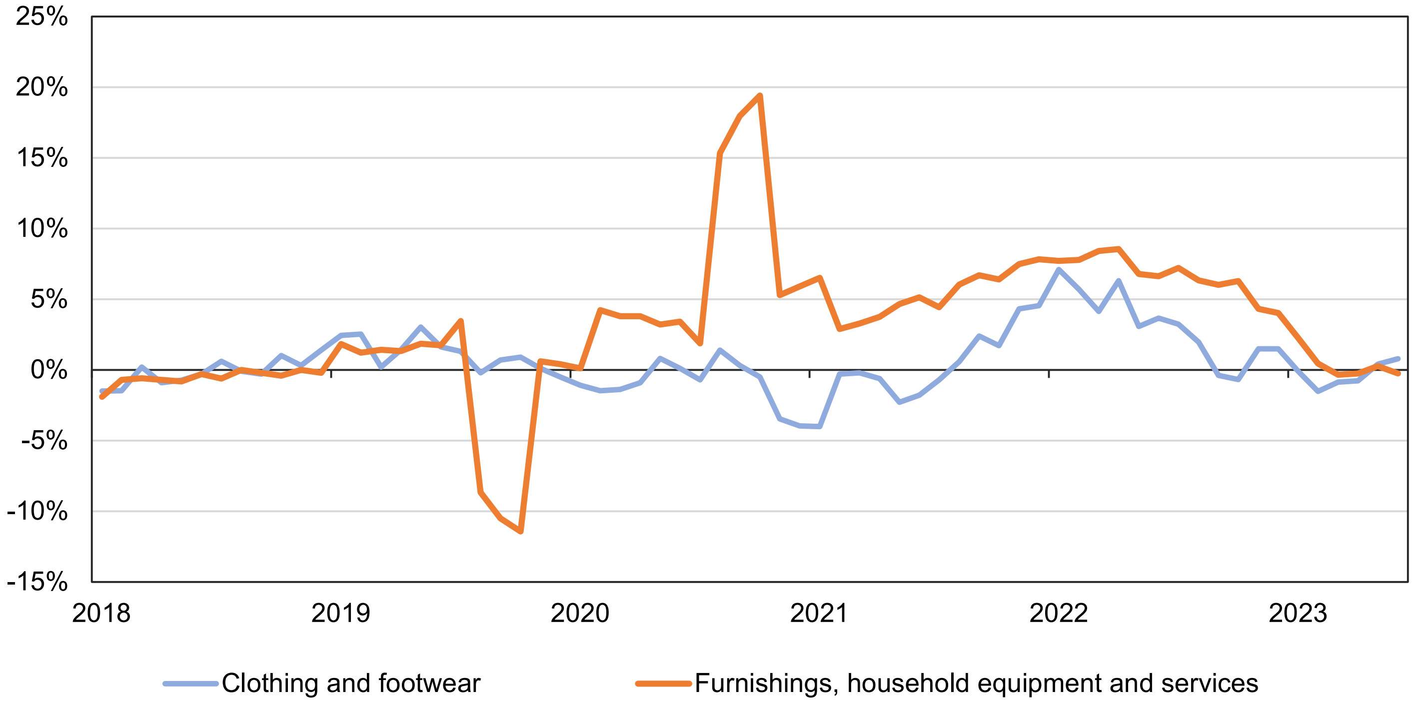
CPI Components



Source: Australian Bureau of Statistics, Auscap

Clothing, footwear and household goods have experienced deflation recently, which has been lowering the overall rate of inflation.

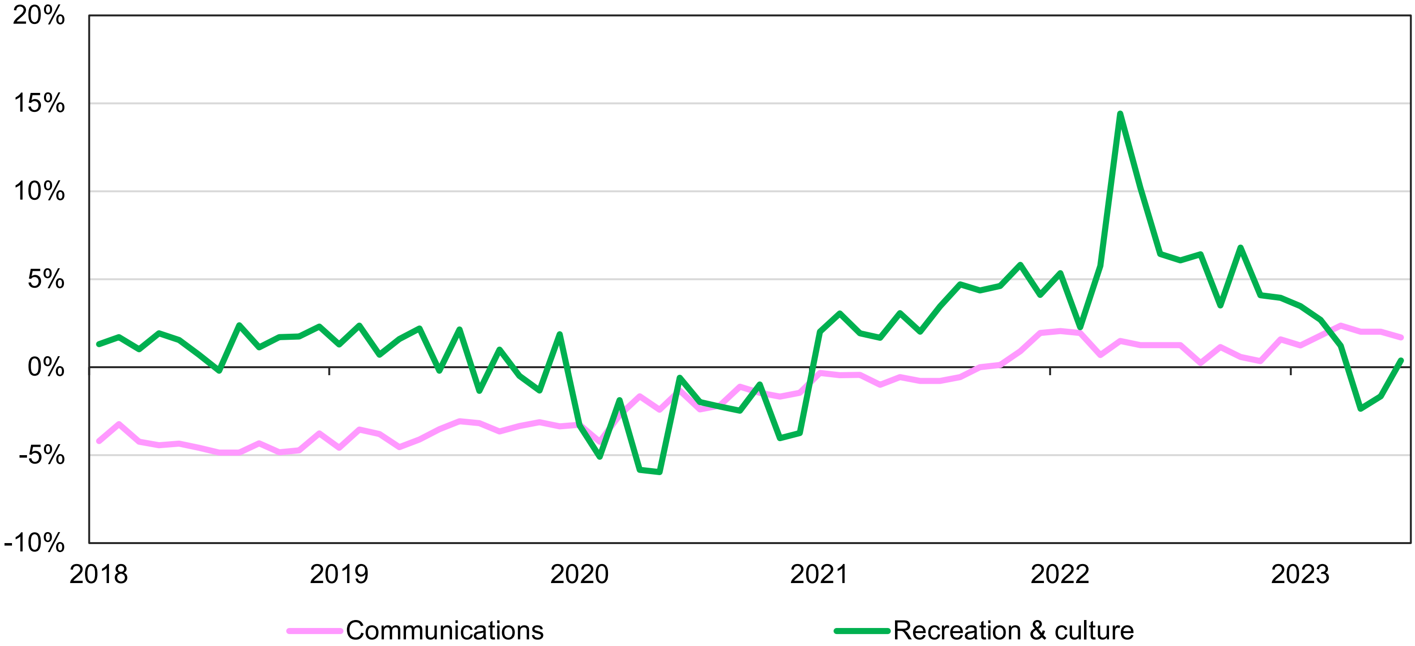
CPI Components



Source: Australian Bureau of Statistics, Auscap

Inflation in communications, recreation and culture appears benign.

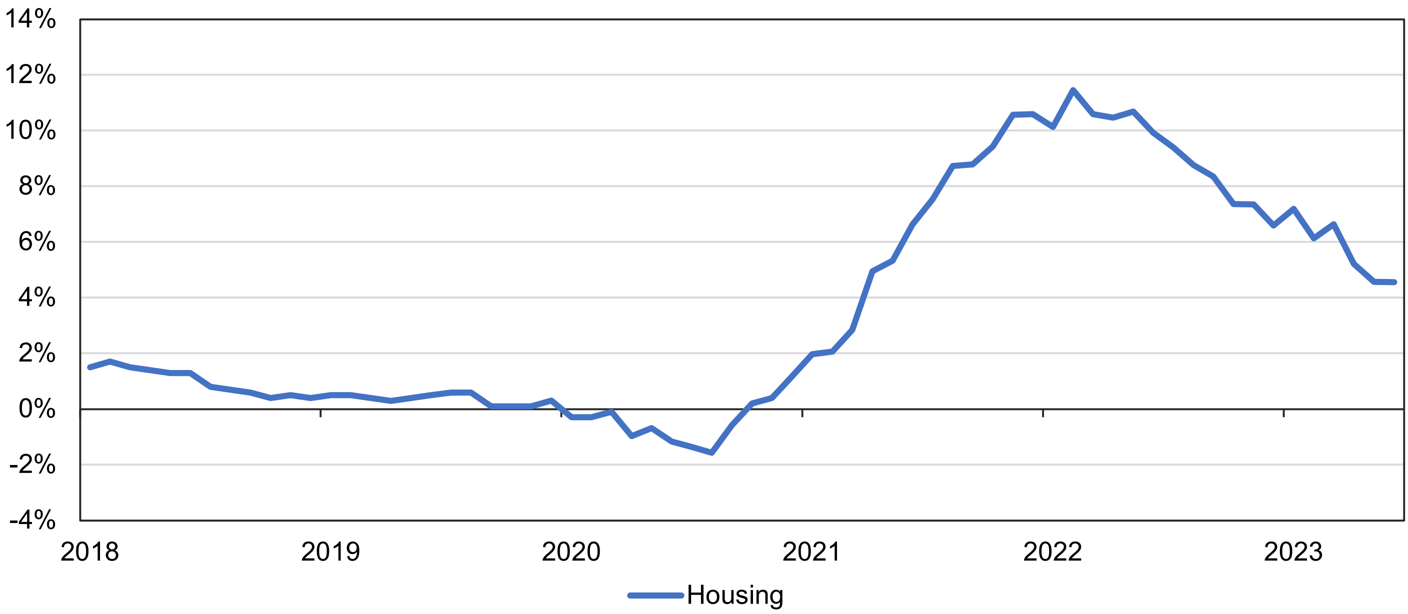
CPI Components



Source: Australian Bureau of Statistics, Auscap

However, there are a number of components where inflation remains concerning. Housing represents 21.7% of CPI, and housing inflation is currently running at 4.6%.

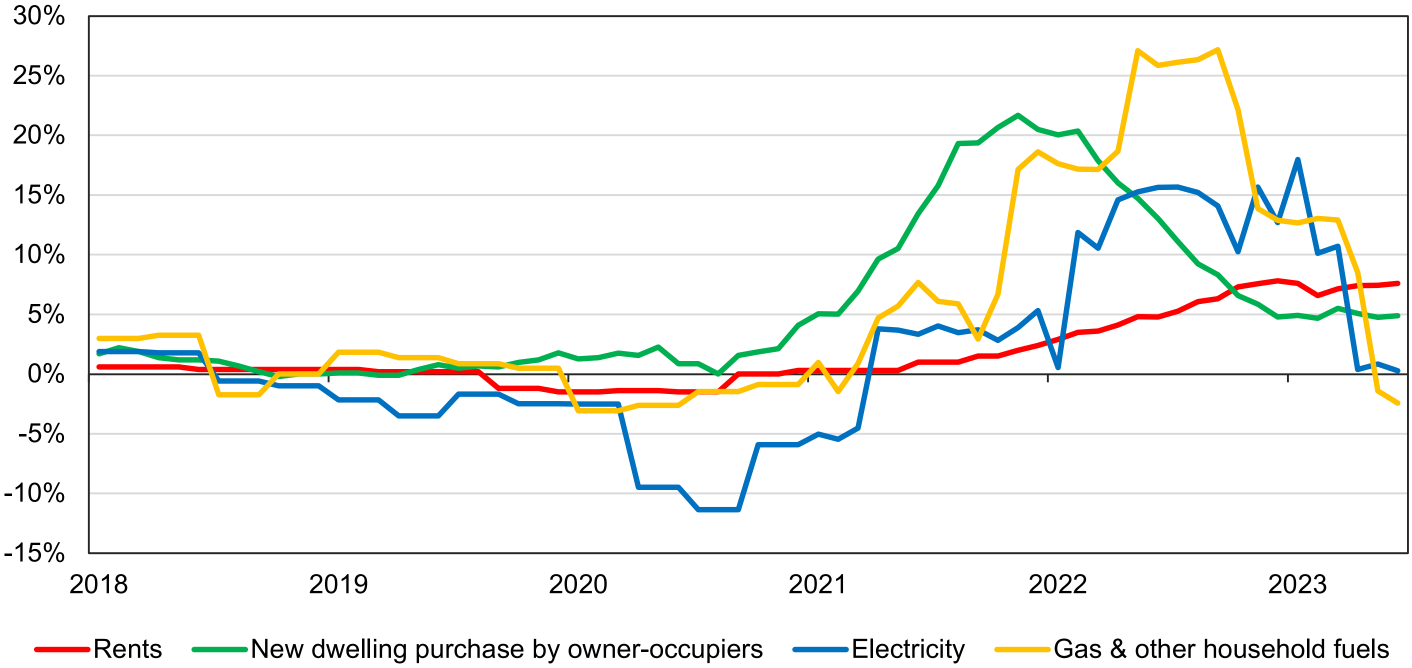
CPI Components



Source: Australian Bureau of Statistics, Auscap

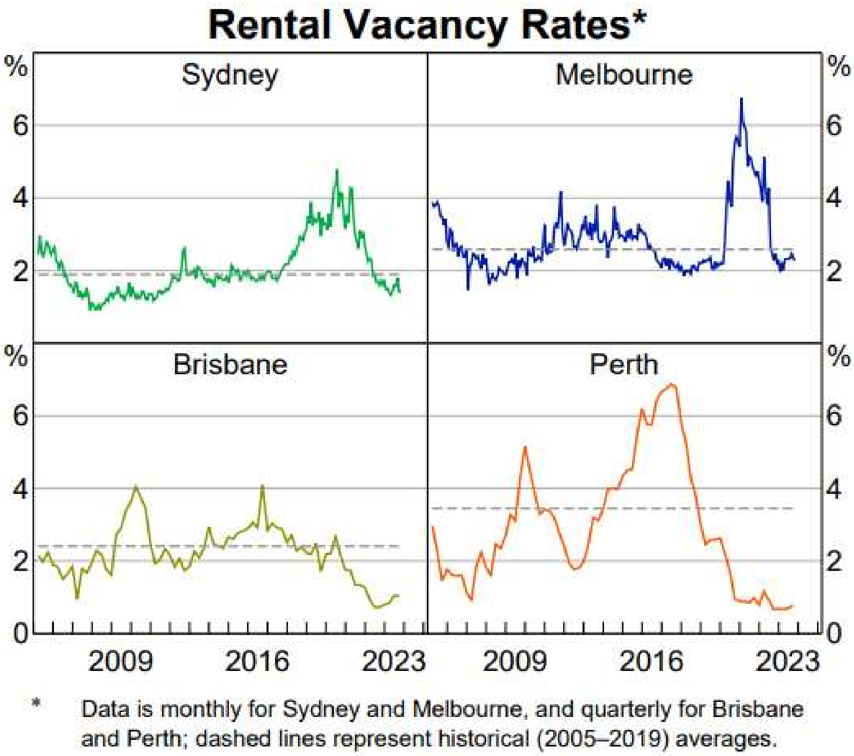
Significantly, within housing, the two biggest components are rent and the cost of new owner-occupier housing, representing roughly 65% of the housing bucket. Rent inflation appears to have bottomed at 6.6% and is now rising again, currently 7.6%. New dwelling purchase inflation also bottomed at 4.7% in October 2023 and is currently 4.9%.

CPI Housing Sub-Components



Source: Australian Bureau of Statistics, Auscap

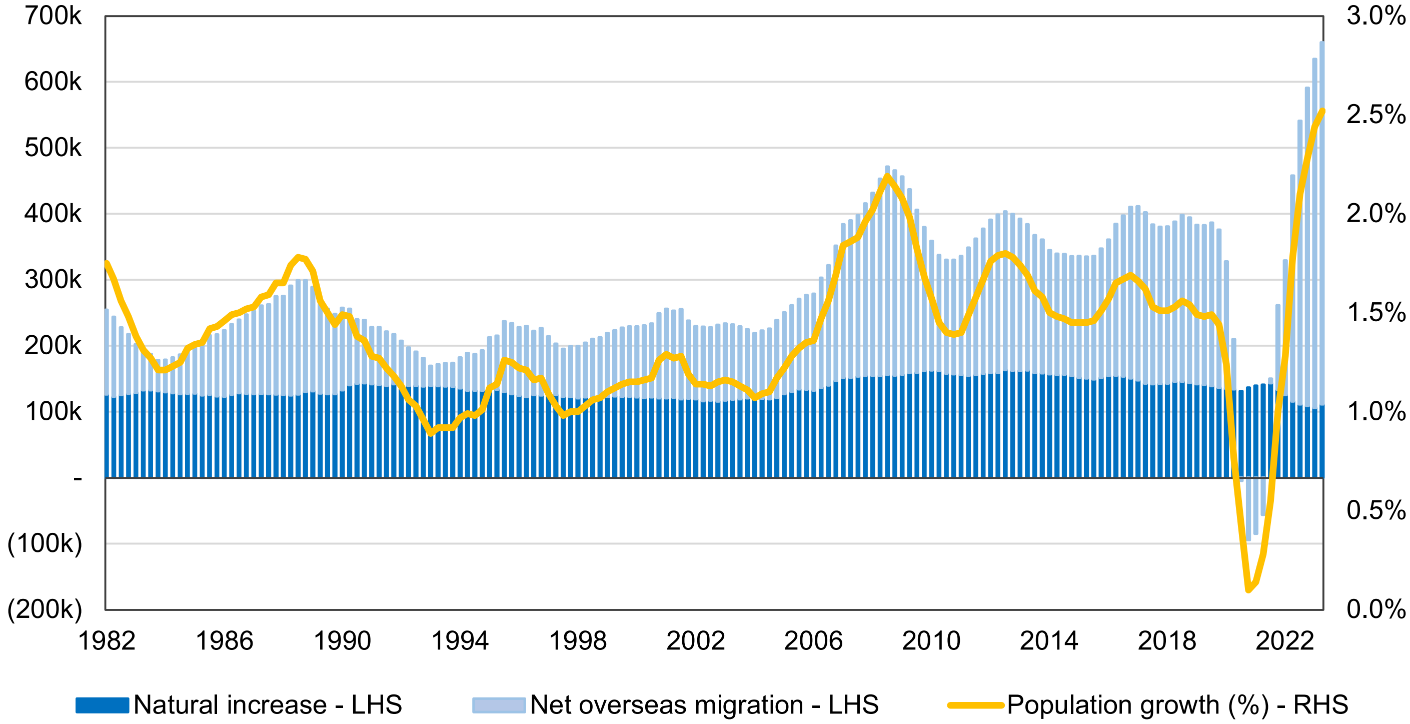
It is difficult to see what factors might ease pressures in the housing market to allow housing inflation to decline. The rental market in Australia, particularly in the capital cities, is extremely tight.



Source: Reserve Bank of Australia

This in an environment in which Australia's population growth is at multi decade highs driven by surging migration.

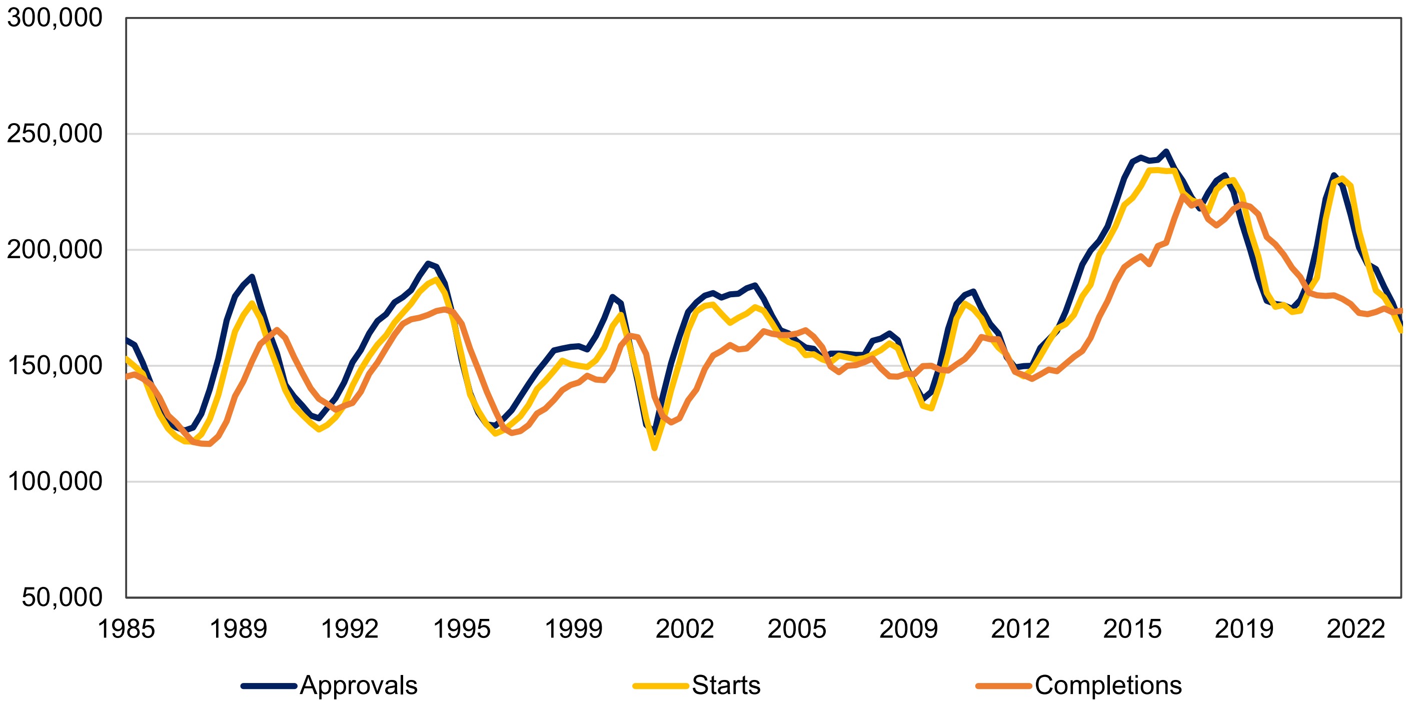
Australian Population Growth to September 2023 (%)



Source: Australian Bureau of Statistics, Auscap

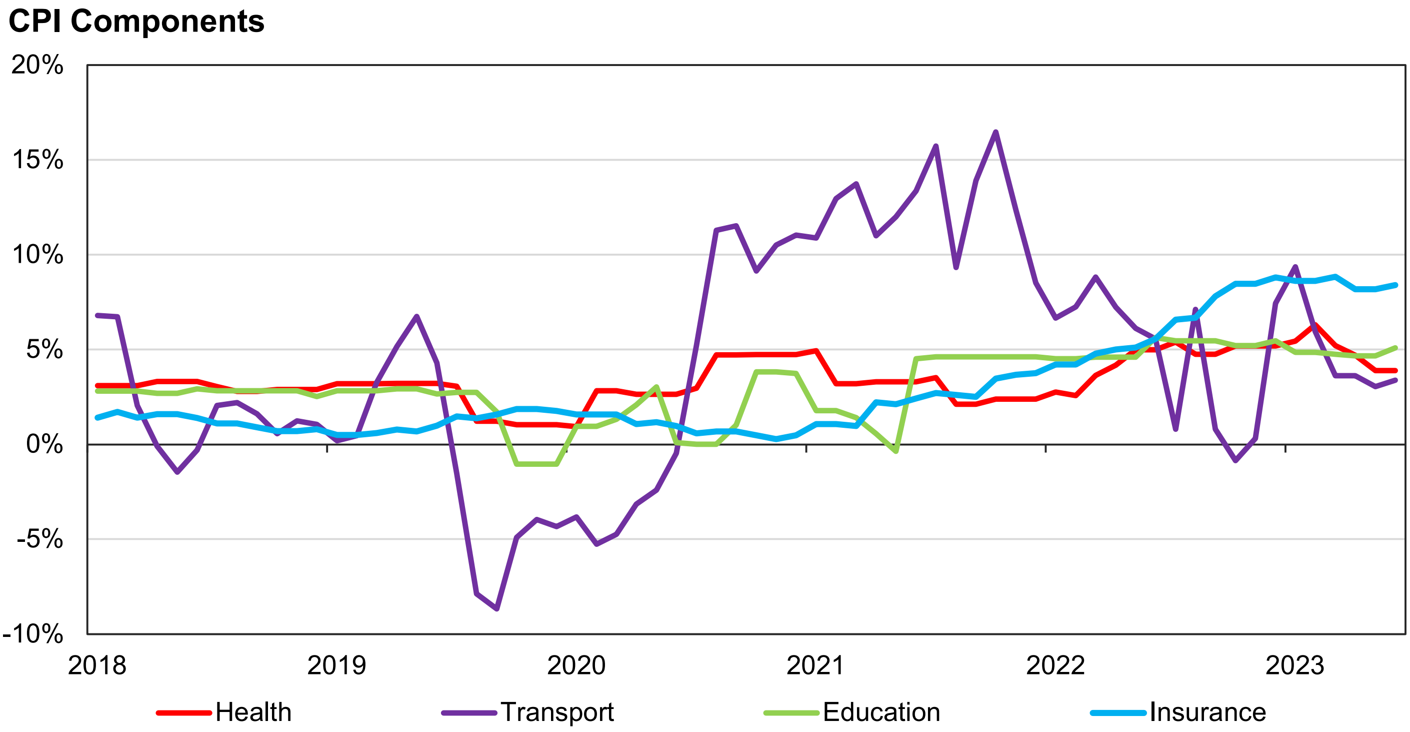
Yet rising interest rates combined with wage and cost inflation is not conducive to encouraging builders to increase commencements. Housing starts are at their lowest ebb in more than a decade.

Housing Approvals, Starts & Completions



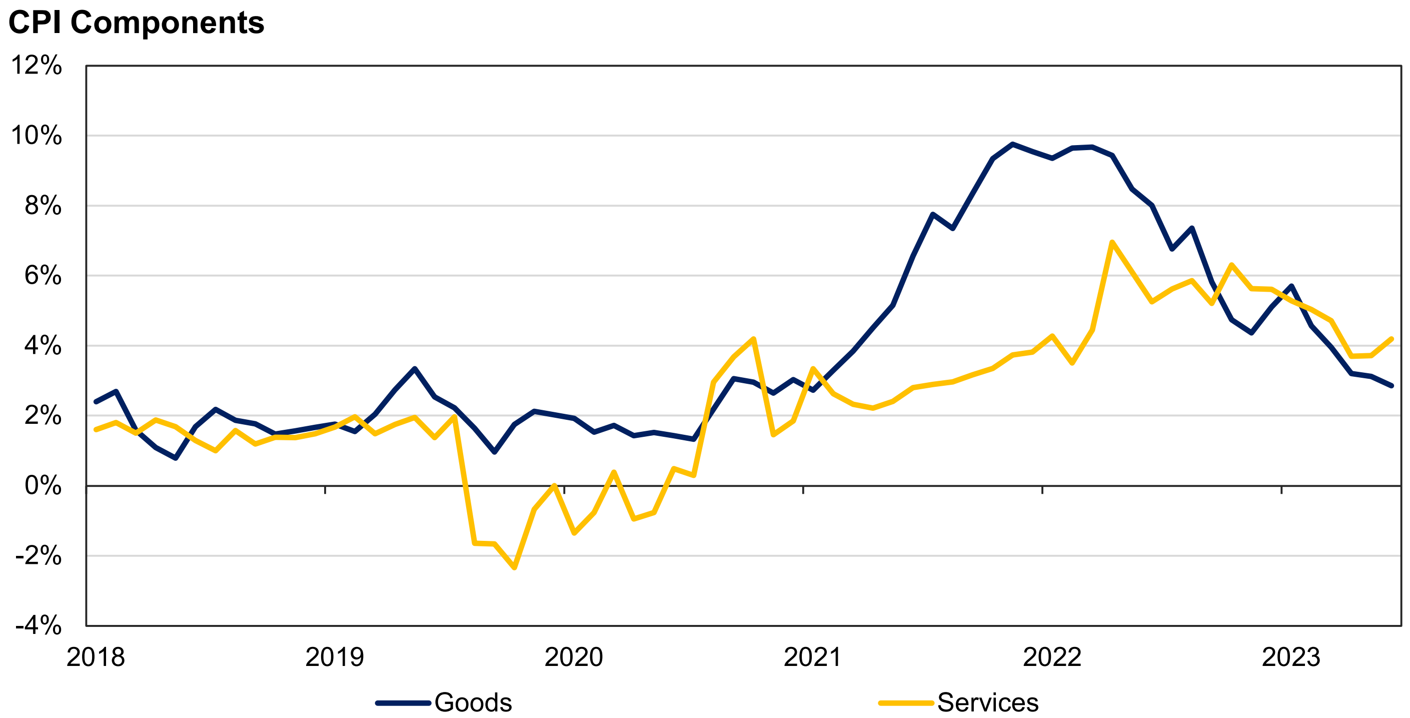
Source: Australian Bureau of Statistics, Auscap

Inflation within the services sector is also problematic. Health, education and insurance inflation are each stubbornly high and above the RBA's target inflation range. Transport is also above the RBA target band, albeit it is a composite of the cost of motor vehicles, fuel, transport services and spare parts for motor vehicles.



Source: Australian Bureau of Statistics, Auscap

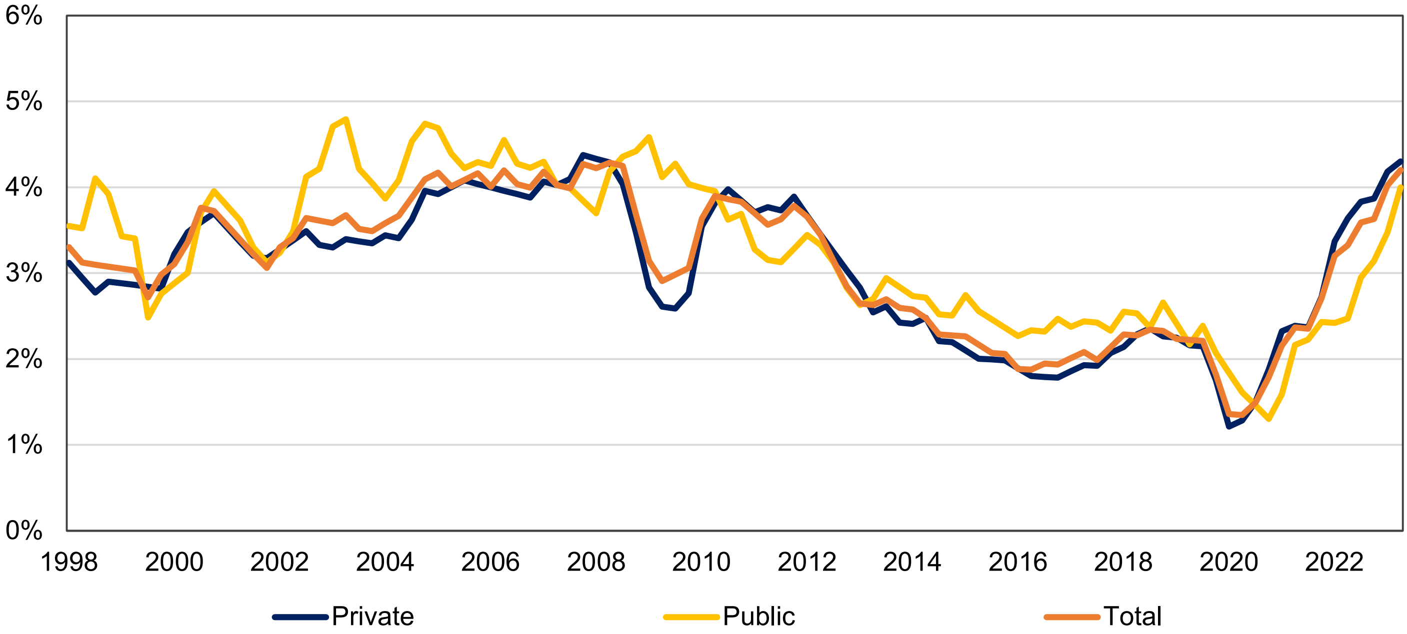
In fact, if we split inflation into goods inflation and services inflation, the latter is currently 4.2% and rising.



Source: Australian Bureau of Statistics, Auscap

This is perhaps not surprising, given the cost of labour is the biggest input into services inflation. Domestic wage growth has not yet shown signs of abating.

Australian Wage Price Index YoY growth (%)



Source: Australian Bureau of Statistics, Auscap

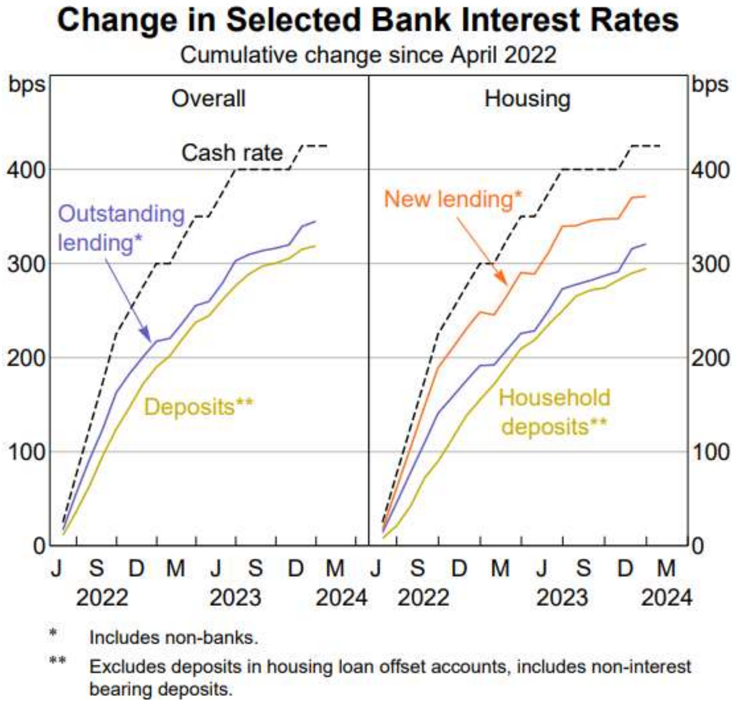
The RBA has discussed one way of thinking about inflation as being the product of labour costs less productivity gains. The problem currently is that nominal unit labour costs have been accelerating while productivity has declined, which theoretically adds to the inflationary impulse.

Source: Reserve Bank of Australia

If inflation persists above the top of the target band, the question is whether there is some other economic imperative so pressing that the RBA should be lowering interest rates irrespective. The RBA's mandate is full employment alongside low and stable inflation, along with exercising their powers to contribute to both the stability of the currency and the economic prosperity and welfare of the people of Australia.

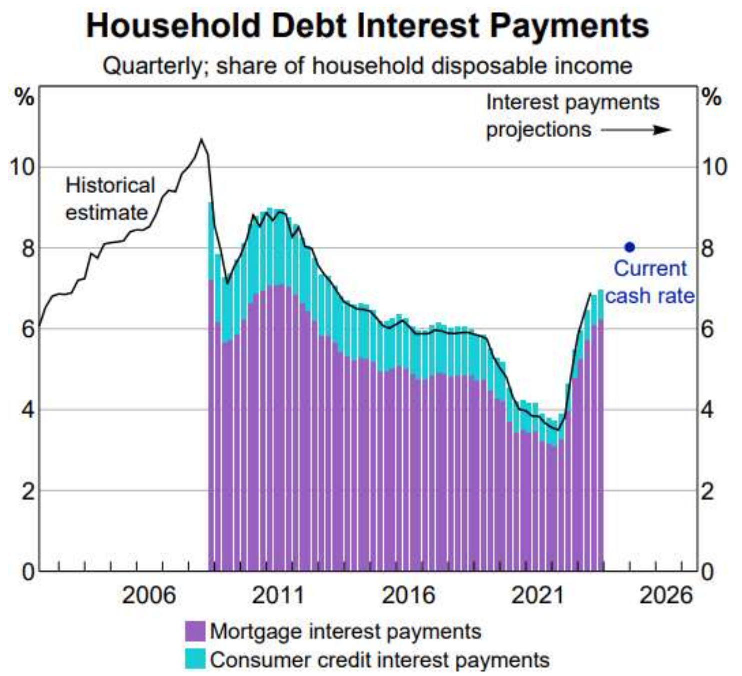
Analysis of a broad range of economic indicators, that we assess below, makes it difficult to presently conclude that these objectives require lower interest rates in the absence of inflation being back in the target band.

Australia has experienced a rapid increase in interest rates. These higher interest rates have not been fully passed on to borrowers at this point, largely due to the continued gradual roll-off of fixed rate mortgages.



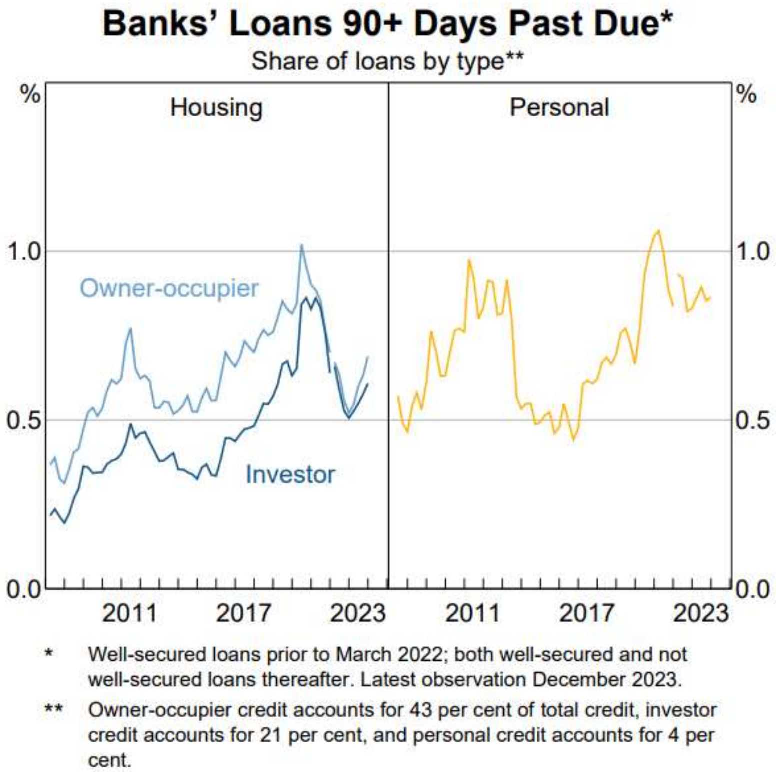
Source: Reserve Bank of Australia

The increase in rates has led to household interest expense as a percentage of disposable income rising to levels not seen for a decade.



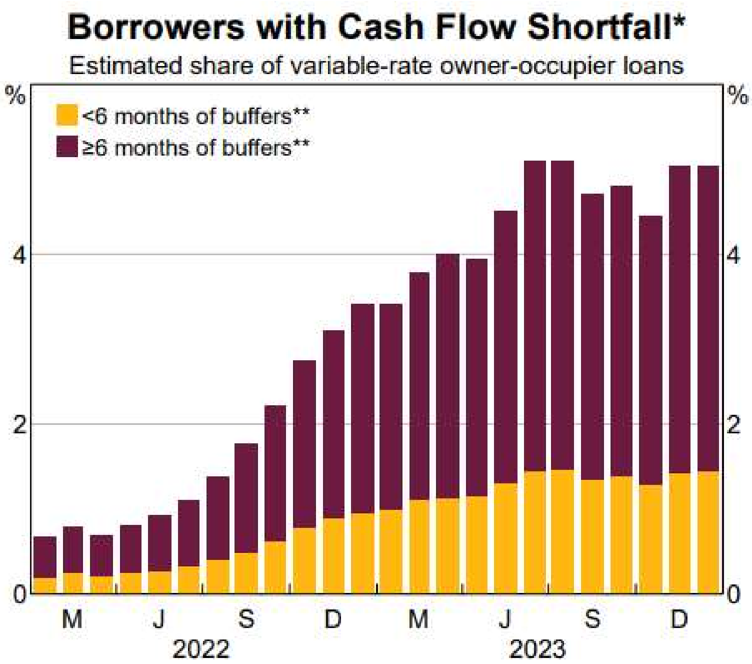
Source: Reserve Bank of Australia

Despite this, bank loans in arrears remain relatively low compared to pre COVID-19.



Source: Reserve Bank of Australia

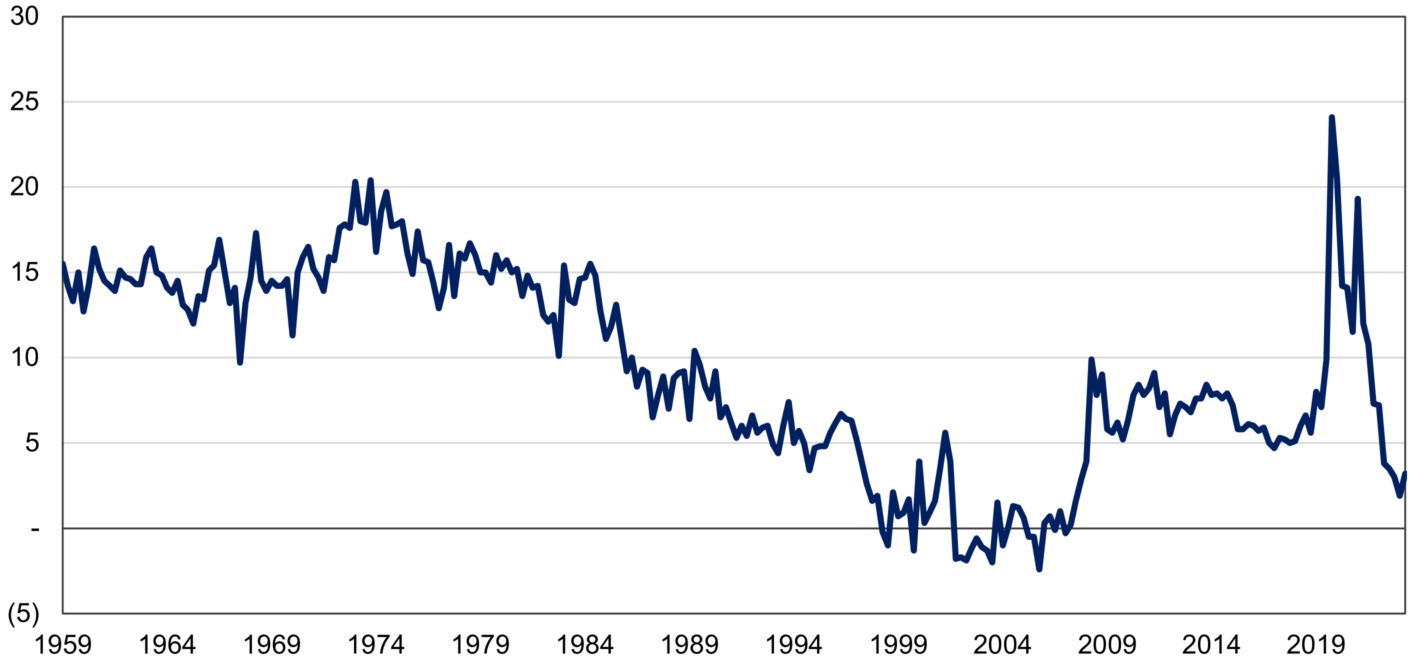
The RBA estimates that at current interest rates approximately 5% of owner occupier borrowers have a cash flow shortfall. But over 65% of this cohort have built up sufficient savings buffers to cover their shortfalls for at least 6 months, as can be seen in the chart below, and according to the RBA in many instances for more than 24 months, which will allow them to weather higher rates for some time. Further, to the extent the mortgage stress forces a sale of the property, buoyant property market conditions reduce the risk to household equity.



Source: Reserve Bank of Australia

The savings rate in Australia remains positive, albeit significantly lower than where it has been since the Global Financial Crisis (GFC).

Household savings ratio (%)



Source: Australian Bureau of Statistics, Auscap

Mortgage buffers remain quite significant, reflective of the fact that the savings built up during and shortly after COVID-19 remain largely intact, and significantly higher than they were in 2018, as can be seen below.

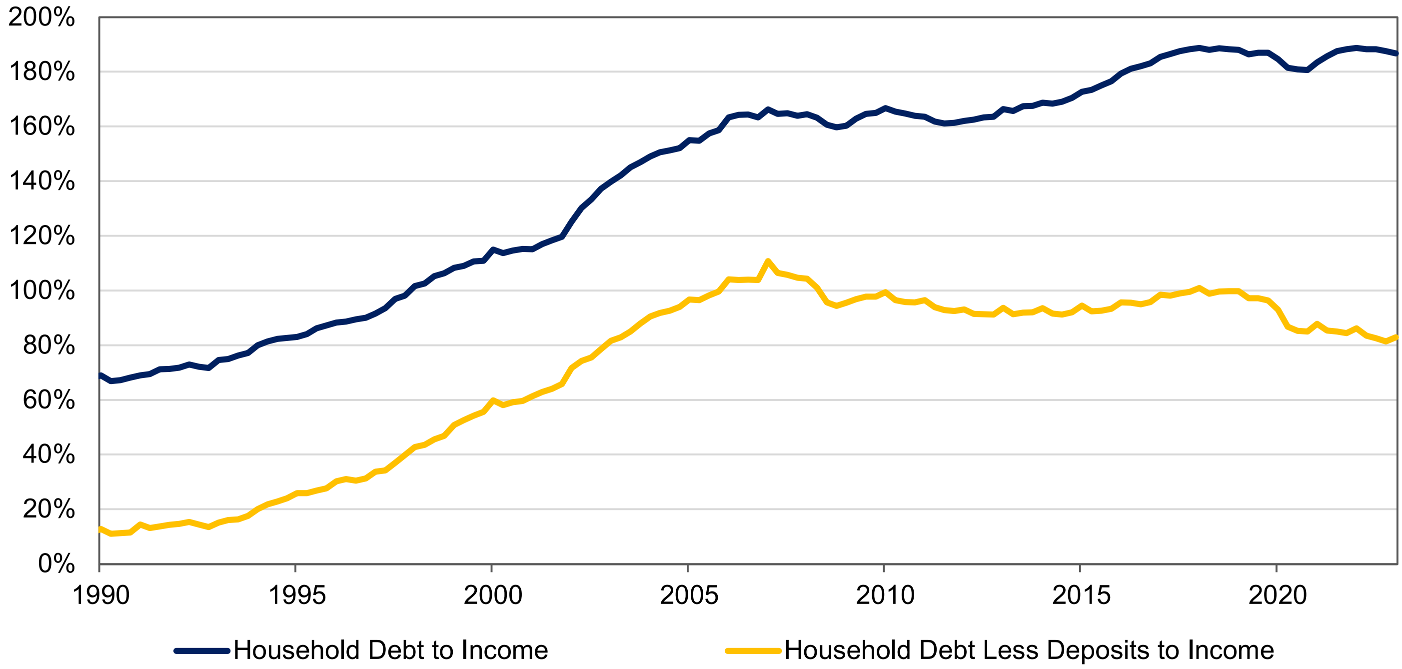
Liquid Savings Relative to Housing and Essential Expenses*

Median household by housing tenure, 2022**

Source: Reserve Bank of Australia

And aggregate household debt less cash held in offset accounts and deposits as a percentage of income is at near 20 year lows.

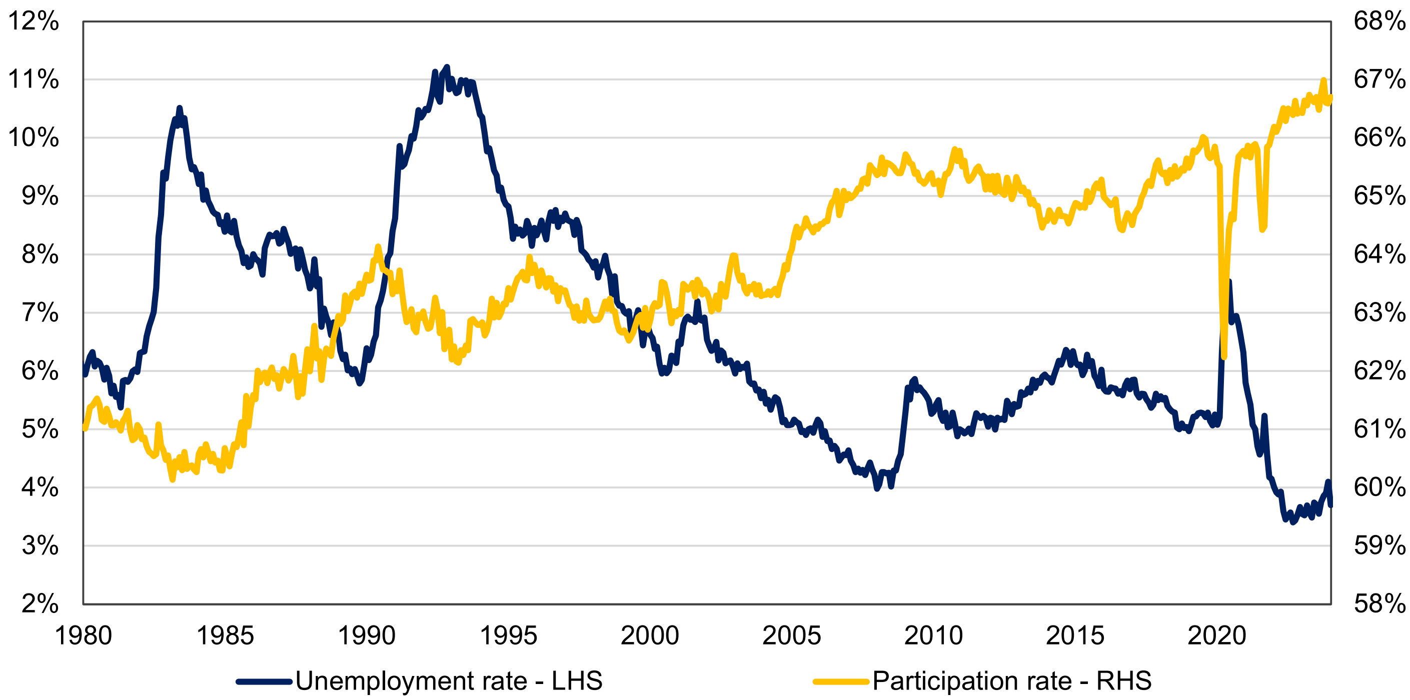
Household Debt



Source: Australian Bureau of Statistics, Auscap

Unemployment in Australia is remarkably low at 3.7%. This is despite the participation rate being at near record levels, with 66.7% of the working age population in the workforce.

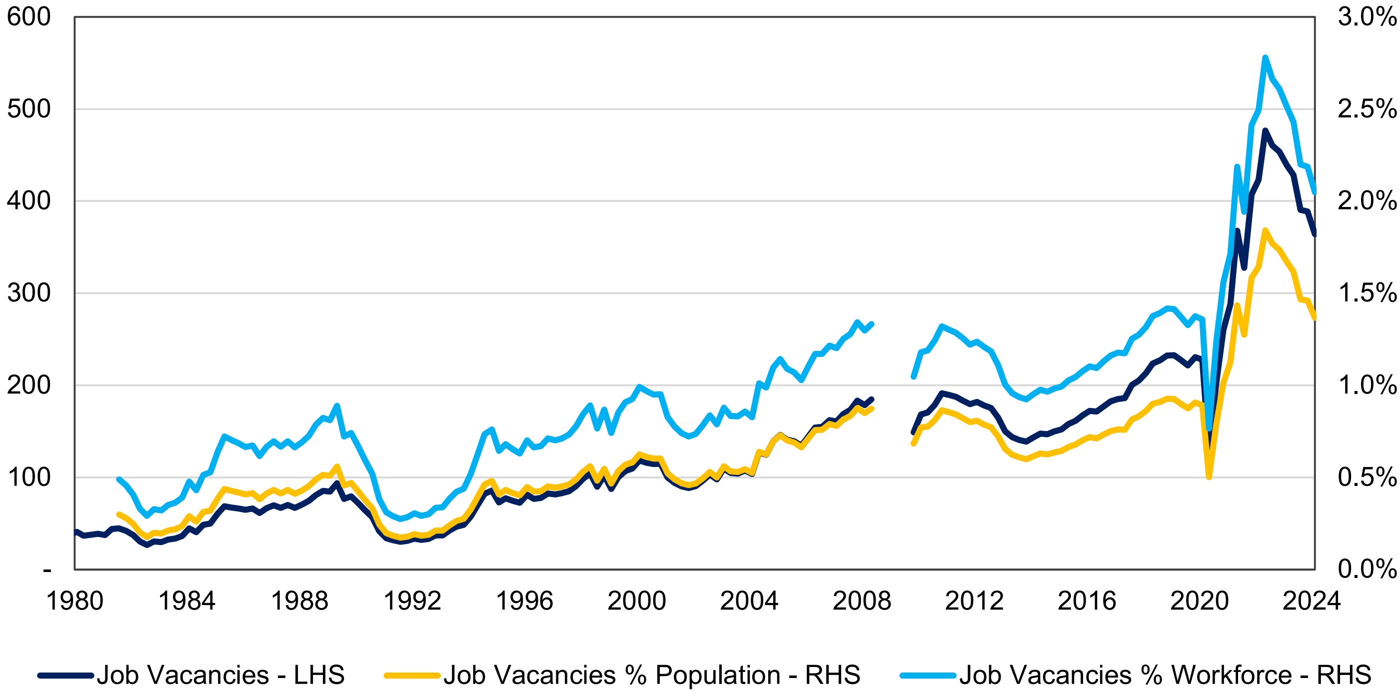
Unemployment Rate & Participation Rate (%)



Source: Australian Bureau of Statistics, Auscap

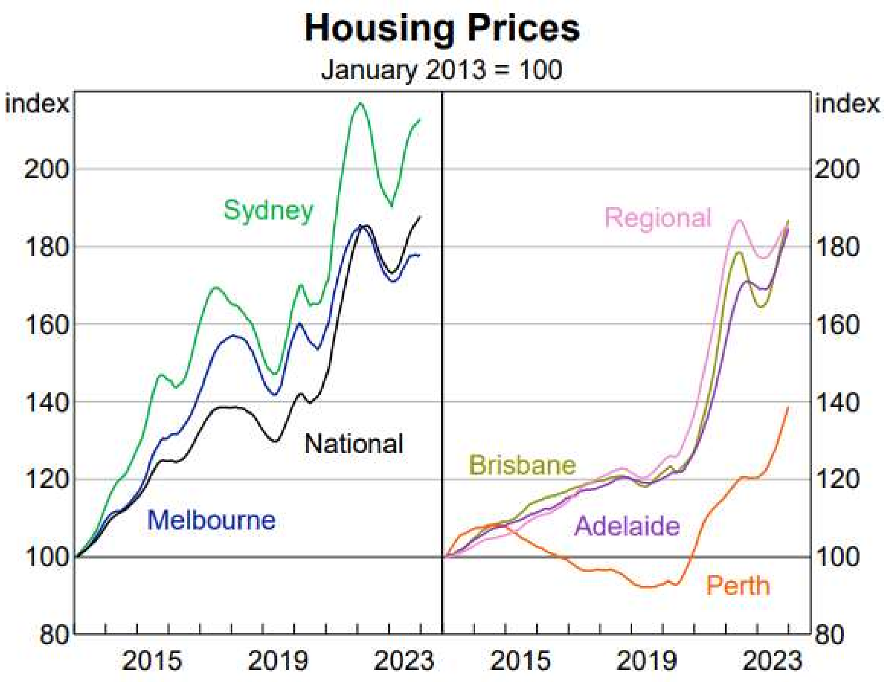
While job vacancies have declined recently, they are still significantly above where they were prior to COVID, suggesting ongoing labour shortages.

Australian Job Vacancies (000s)



Source: Australian Bureau of Statistics, Auscap

And these job vacancies persist despite population growth being at its highest levels in many decades, which supports economic growth, demand for goods and services and keeps the housing rental vacancies at very low levels. This has also no doubt contributed to house prices nationwide being at record highs.



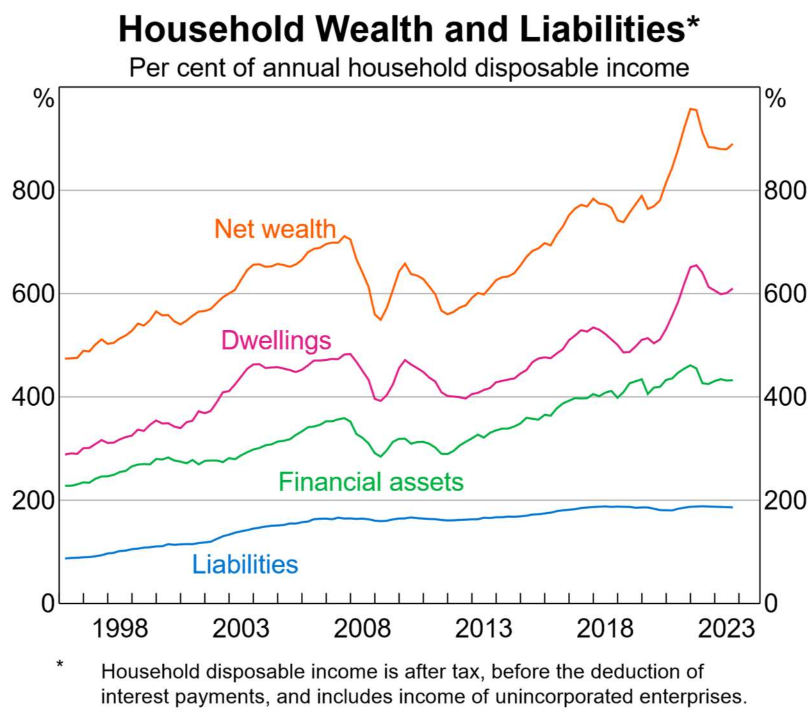
Source: Reserve Bank of Australia

Sharemarkets are also at record highs.

Australian Stockmarket Performance

Source: Bloomberg, Auscap

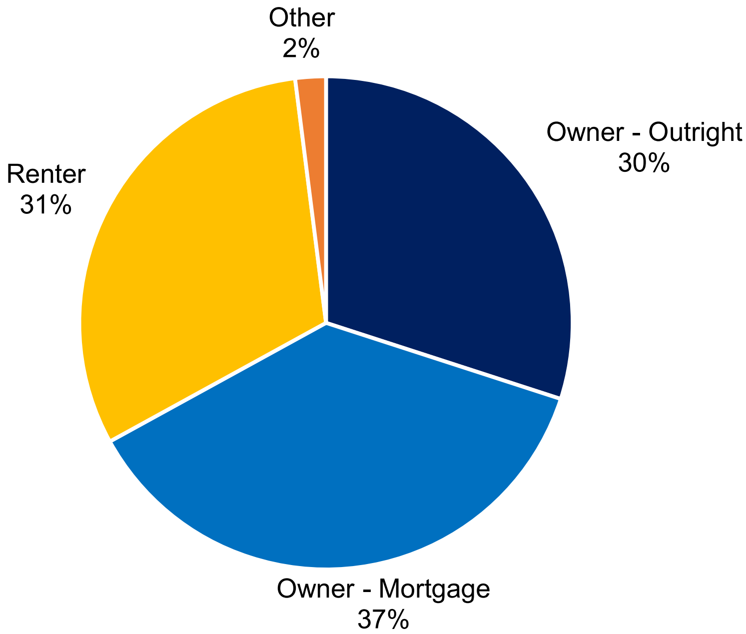
Leading to high levels of household wealth.



Source: Reserve Bank of Australia

The distribution of effects from rising interest rates is uneven. The last Australian Bureau of Statistics household income and wealth survey indicated that 29.5% of households own their own home outright, as compared to 36.8% of households that have a mortgage.

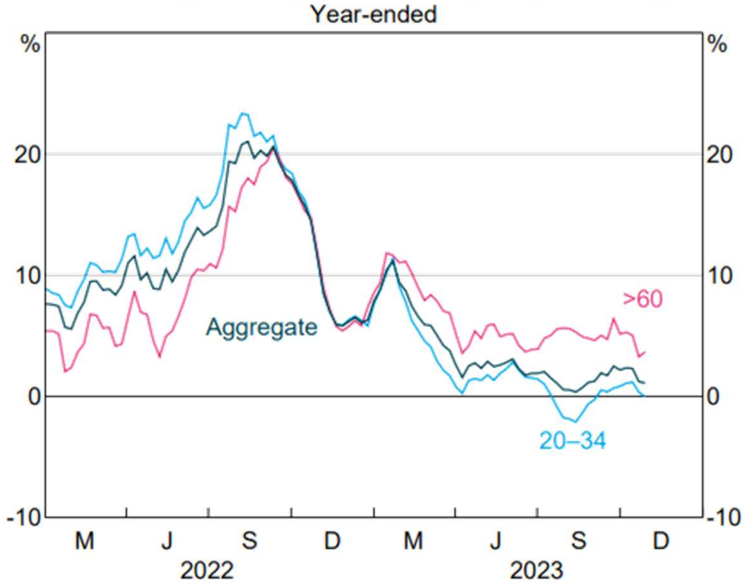
Australian Home Ownership - 2020



Source: Australian Bureau of Statistics, Auscap

Assuming that those who own their home outright on average have savings, from a cash flow perspective this large group benefit every time interest rates go up, because it leads to greater disposable income from cash earnt on deposit, while the group with a mortgage bear the stress of lower disposable income. This has led to different outcomes in consumption over the course of higher interest rates. As CBA highlighted recently, the spending growth rate of those in the 20-34 year old category has declined more significantly than those above 60 years old, the group more likely to have less mortgage debt and greater interest earning assets.

Card Spending Growth by Age Group



Sources: CBA; RBA.

Unfortunately the RBA's tools are blunt and cannot target particular groups. They are designed to work in aggregate, but the effects can be uneven and potentially unfair. It is up to the Government to ensure the effects are fair through redistribution measures available to them. To us it appears that the economy in aggregate is resilient. This leaves the question, if inflation remains above the top of the target band, is it a fait accompli that the RBA will reduce interest rates? Our conclusion is that it may be dangerous to make any investment premised on lower interest rates. While there are a range of possible outcomes, of which significantly lower interest rates is one, at this stage it does not appear to be particularly likely, let alone the most probable outcome.

Auscap Long Short Australian Equities Fund

Fund Performance*

Period	Auscap	All Ords
March 2024	3.5%	3.1%
Financial Year To Date	27.0%	13.8%
Since Inception (Dec 2012)	440.7%	186.0%
Annualised Returns	16.1%	9.7%

Fund Exposures

March 2024 Average	% NAV	Positions
Gross Long	94%	36
Gross Short	0%	0
Gross Total	94%	36
Net / Beta Adjusted Net+	94%	111%

Portfolio Commentary*

The Fund returned 3.5% net of fees during March 2024. This compares with the All Ordinaries Accumulation Index return of 3.1%.

All sectors except communication services contributed positively to returns. The Fund's exposures to the consumer discretionary, healthcare, financials, materials and real estate sectors contributed most significantly.

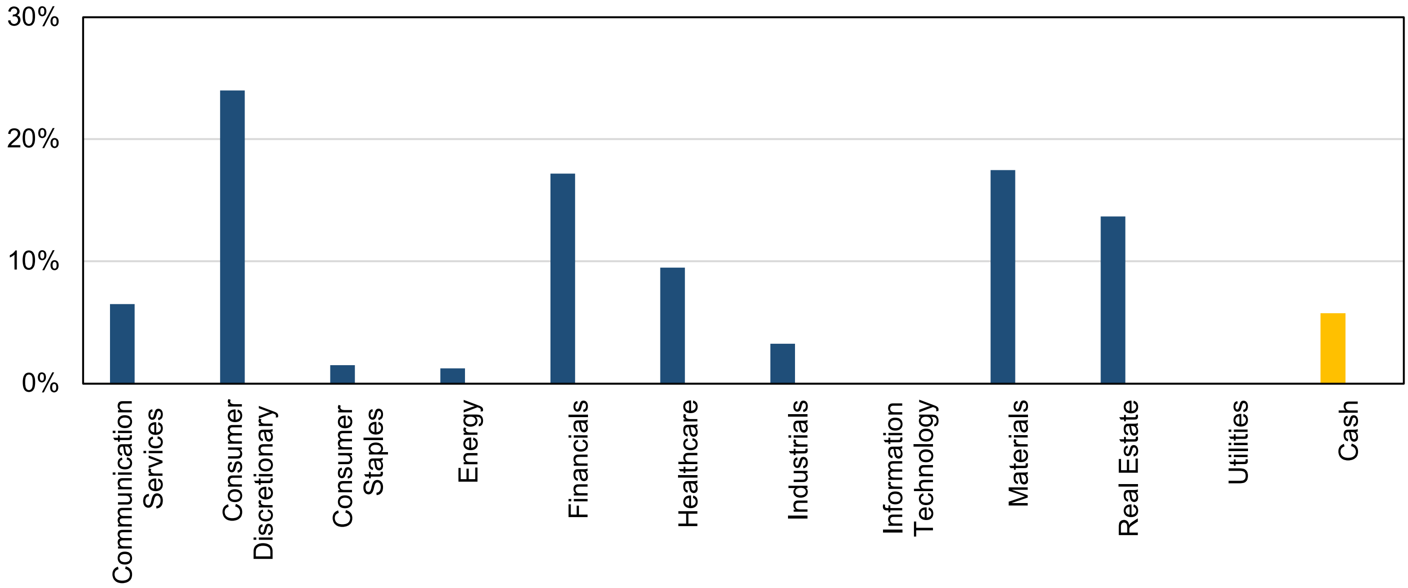
This was led by the Fund's exposures to ResMed, Nick Scali, NIB Holdings and PSC Insurance.

Pilbara Minerals was the largest detractor from the Fund during the month.

Top 20 Investments^

ARB Corp	Mineral Resources
Breville Group	NIB Holdings
CAR Group	Nick Scali
Charter Hall Retail REIT	Pilbara Minerals
Eagers Automotive	PSC Insurance
HMC Capital	PWR Holdings
HomeCo Daily Needs REIT	REA Group
HUB24	Reece
James Hardie Industries	ResMed
Macquarie Group	Sonic Healthcare

Sector Exposure - March 2024#



Performance figures are calculated for the Monthly Class net of all fees and expenses and assuming the reinvestment of all distributions. Note, as at 1 January 2021, the Series Class was consolidated into the Monthly Class. Past performance is not a reliable indicator of future performance.

\+ *Beta adjusted net adjusts the portfolio for the beta, or share price volatility, of the stocks relative to the All Ordinaries Accumulation Index.*

^ *Top 20 long investments in alphabetical order as at 31 March 2024.*

\# *Average sector exposure during March 2024.*

Auscap Ex-20 Australian Equities Fund

Fund Performance*

Period	Auscap	Index**
March 2024	3.6%	4.3%
Financial Year To Date	19.3%	15.5%
Since Inception (Dec 2023)	19.3%	15.5%
Annualised Returns	NA	NA

Fund Exposures

March 2024 Average	% NAV	Index
Equities	97%	100%
Cash	3%	0%
Beta Adjusted Exposure+	105%	102%
Positions	50	

Portfolio Commentary*

The Fund returned 3.6% net of fees during March 2024. This compares with the S&P/ASX 300 Ex S&P/ASX 20 Index return of 4.3%.

The Fund's exposures to the financials, health care, industrials, materials and real estate sectors contributed most significantly.

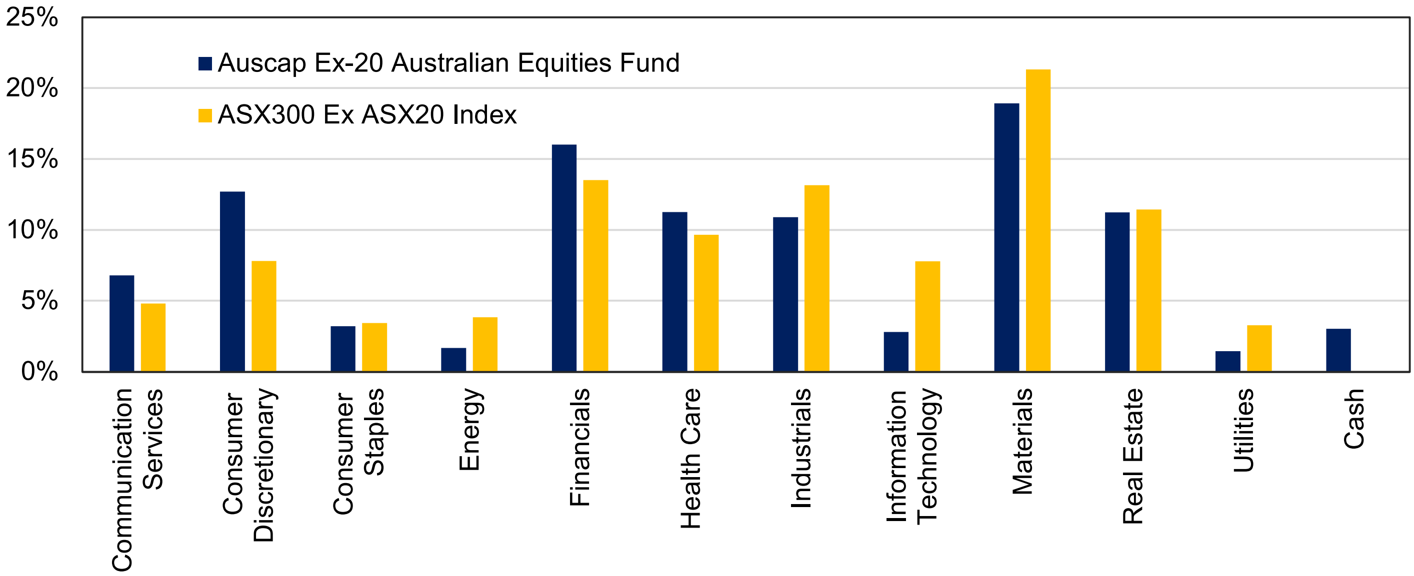
This was led by the Fund's exposure to ResMed, NIB Holdings, Mineral Resources and Nick Scali.

The Fund's exposures to the communication services and information technology sectors detracted from returns. Pilbara Minerals was the largest detractor from the Fund.

Top 20 Investments^

CAR Group	Pilbara Minerals
Charter Hall Retail REIT	PSC Insurance
Cochlear	PWR Holdings
HMC Capital	Qube Holdings
HomeCo Daily Needs REIT	REA Group
HUB24	Reece
James Hardie	Reliance Worldwide
Mineral Resources	ResMed
NIB Holdings	Sonic Healthcare
Nick Scali	Wisetech Global

Sector Exposure - March 2024#



* *Performance figures are calculated for the General Class net of all fees and expenses and assuming the reinvestment of all distributions. Past performance is not a reliable indicator of future performance.*

** *Index used is the Benchmark for the Ex-20 Fund, being the S&P/ASX 300 Ex S&P/ASX 20 Index.*

\+ *Beta adjusted exposure adjusts the portfolios for the beta, or share price volatility, of the stocks relative to the All Ordinaries Accumulation Index.*

^ *Top 20 investments in alphabetical order as at 31 March 2024.*

\# *Average sector exposure during March 2024.*

Newsletter – April 2024

Auscap Asset Management

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