JBWere

Medical Assurance Society

Investment Update

8 July 2021

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Markets Outlook: A New Phase

With vaccine rollouts underway and a number of major economies in the process of reopening, confidence in the global economic recovery continues to grow. According to Bloomberg, consensus forecasts for global real GDP growth this year now sit at 6%, up from around 5% at the start of the year. This positive economic momentum is also reflected in corporate earnings expectations, which have continually been revised higher. Together with stimulatory central bank settings, this economic acceleration has provided a key tailwind for global share markets, and with it, overall investment returns this year.

As we look to the second half of the year, there are some factors that are posing challenges to the economic picture. The ever-present risk of virus mutations and fresh COVID-19 outbreaks is something that needs to be monitored. Demand and supply imbalances are also resulting in clear pricing tension in some sectors (and labour markets), contributing to a spike in inflation rates recently, and it has further to run in our view. Yet, just as our base case is that vaccines prove effective against current and new COVID-19 strains, we see these supply-side disruptions eventually normalising, ensuring current elevated inflation pressures prove largely temporary, keeping the positive economic outlook story very much intact.

Indeed, this positive economic picture and reduced downside risks has led to a shift in rhetoric from some central banks as they start to signal a pivot away from maximum policy accommodation. Locally, our own Reserve Bank of New Zealand has joined this camp, signalling the potential for interest rate hikes from next year. For investors, rather than something to necessarily fear, this shift should be viewed as a vote of confidence in the recovery, especially as the process of reducing monetary policy stimulus is likely to be gradual and well signalled over the months and years ahead.

That being said, what this shift from some central banks does signal, together with an approaching 'peak' in global growth momentum, is that we are now entering a new 'phase' of the market cycle. The past 12 months has seen strong investment returns, led by higher equity markets, and equity market valuations especially. This is very common in the initial stages of a cycle. But as expectations of economic recovery shift to the reality of recovery (where we are today), equity market returns are typically more modest, and the drivers of share prices shift from valuations to earnings growth, with a more balanced risk/return outlook overall.

It is also a phase of the cycle likely to be accompanied by less consistent market leadership than seen year-to-date. In other words, a move away from the clear beneficiaries of economic reopening (like banks, industrials and some travel and hospitality related sectors for example) and towards stocks, sectors and investment themes that are expected to outperform in a post-COVID world. For us, some of the investment attributes of the companies expected to do well going forward reflect quality characteristics like pricing power and margin resilience, dividend sustainability, and free cash flow generation.

MAS Portfolio Implications

For the past six months, we have maintained a higher allocation to growth (equity) assets relative to their strategic targets within the MAS Funds, and this position has served the Funds extremely well given relative equity market returns. However, following a recent decision by MAS to increase the strategic asset allocation weightings to growth assets (in part reflecting the lower future returns expected from cash and fixed interest), the Funds' growth asset exposure is now at a broadly neutral level. Given our more balanced assessment of equity market risks over the coming months discussed above, this neutral position is something we are comfortable with, and we see it as prudently managing risks after a strong run of equity market performance. Currently, the Funds are also broadly neutral versus target in fixed interest and cash, although we intend to use these asset classes as funding sources to add back to equities exposure on any meaningful market weakness going forward.

We believe the highly diversified approach we take to investing will serve the MAS Funds well over the months ahead and into a post-COVID world. But that diversified approach does not mean we aren't continually assessing MAS' current holdings or looking for new investment opportunities, especially with the attributes mentioned earlier that we expect to perform well over the remainder of this cycle. Over the past quarter, some of the meaningful changes we have made within the Australian equities portfolio include:

- Introducing **Summerset Group** and **Oceania Healthcare.** We have been doing work on these two names for a while and watching the news flow keenly for positive catalysts as we look to increase and diversify the Funds' exposure to the domestic aged care sector. Summerset recently reported a strong 1Q21 sales update and the outcome of the Australian Government's budget and response to the Royal commission report are positive for their Australian development pipeline. Oceania's result near the end of May gave us confidence in their outlook over the next 12 months and we believe their earnings will continue to grow ahead of expectations. Their recent capital restructuring and low gearing should help support strong earnings growth going forward.
- Divesting **Z Energy**. Our thesis for holding a position in Z Energy was that the company was highly leveraged to benefit from a return to economic normalisation post COVID lockdowns. However, that hasn't played out as expected due to declining margins and market share, hampering earnings growth. Combined with the fact that a potential change in MAS' responsible investing criteria would mean that Z Energy became an excluded investment in the near future, the decision was made to exit this position and redeploy these funds into other opportunities.
- Introducing **Xero**. Xero is a long-term beneficiary of GDP growth and new business formations. We expect there will continue to be growth in the penetration of cloud-based accounting software, particularly in the US and UK, and that Xero can increase its market share in those markets. We believe there will be continued demand for third-party business management apps available through the Xero ecosystem and that recurring revenue for business-critical software provides some near-term earnings certainty. The recent pullback in the share price also provided an attractive entry point.
- Introducing **Ramsay Healthcare**. Ramsay is the largest private hospital operator in Australia and has operations in Europe and the UK. We believe it has favourable growth prospects underpinned by demographics, strong private health participation in Australia and France, and NHS outsourcing initiatives in the UK. The company currently trades on an undemanding multiple given current earnings momentum and we believe is a good addition to the portfolio.

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