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Fisher Funds Market Insights

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A strong first half for investors

Ashley Gardyne, Chief Investment Officer

Markets have had a strong start in 2023, with share markets outstripping defensive asset classes like bonds and cash. The sudden shift in market sentiment and economic data in 2023 is an important reminder that portfolios need to be multi-dimensional and include investments that perform in different environments – balancing offence and defence. After a tough year in 2022, we are pleased that our funds are outperforming the market in 2023.

Global share markets have proved buoyant in 2023, despite the list of issues still facing the global economy – from elevated inflation to the recent US debt ceiling overhang, and to mortgage rates and cost-of-living concerns driving recessionary fears. Despite low investor expectations going into the year, global share markets are up c.14% and tech-heavy indices like the Nasdaq Composite have gained over 30%.

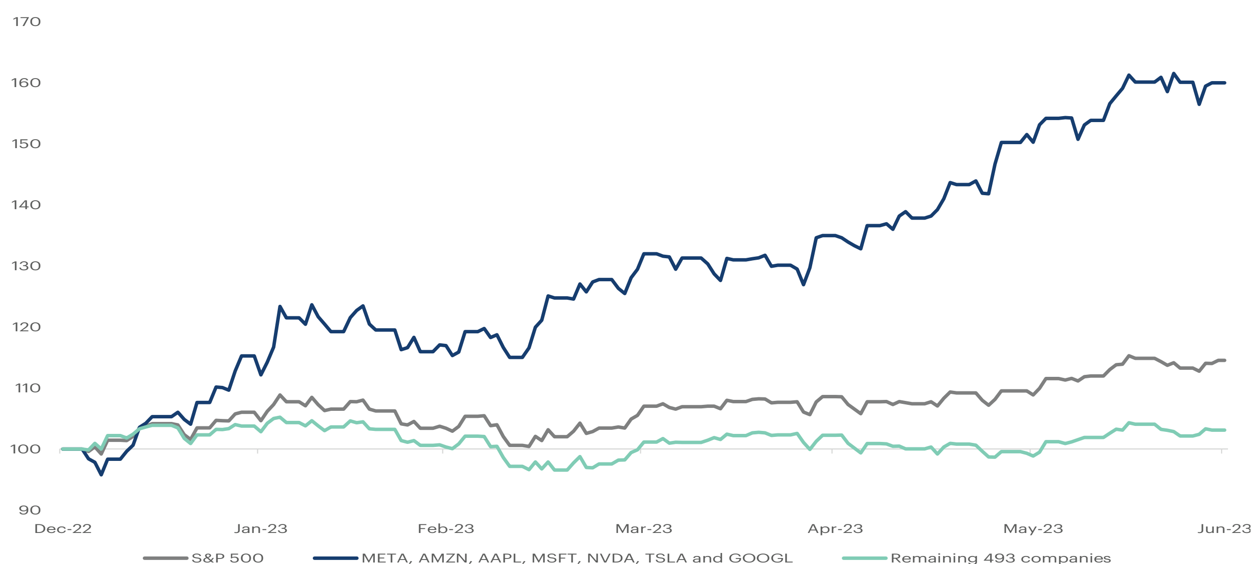
The elevated market volatility and dispersion in the market provided richer pickings for our team in late 2022 and the first half of 2023. This allowed our Portfolio Managers to reposition portfolios and add new companies at more attractive valuations. The team's efforts are starting to pay off and we remain optimistic about the outlook for our portfolios.

A different set of investments leads the pack in 2023

In stark contrast to last year, the best performing asset class of 2023 has been global shares, with the US (+16%) in particular performing strongly. While cash or term deposits provided ballast to portfolios in last year's falling market, this year it has acted like an anchor, with returns on cash failing to outstrip the rate of inflation.

Last year's outperforming sectors – energy (due to surging oil prices) and utilities (due to their defensive characteristics) – are lagging in 2023. Both these sectors are down -7% year-to-date. In contrast, last year's laggard, information technology, has rallied strongly with the S&P 500 IT Index gaining +42% so far this year. As the chart below shows, almost all gains in the US share market this year have been driven by just a handful of technology companies.

Chart 1: Performance of US S&P 500 Index including and excluding Big-Tech



Source: Bloomberg

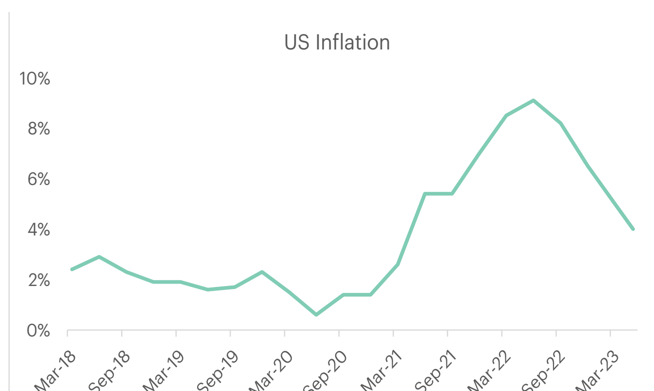
This reversal of fate should serve as a healthy reminder to not go chasing last year's winners. In fact, investors are often better off investing in assets that are temporarily out of favour.

Different issues in 2023 – is a different approach needed?

Last year's risk du-jour was rising inflation and the chance of a 1980's-esque inflationary spiral. These issues are no longer centre stage. Recent data in the US, Europe and New Zealand has demonstrated that these inflationary pressures are easing and were (at least partly) temporary aftershocks of the pandemic. In New Zealand, the narrative has also changed recently, with the Reserve Bank of New Zealand indicating an end to the interest rate hiking cycle. Inflation is starting to normalise and the impacts of higher interest rates are visible in the economy (such as falling house prices and weak retail sales).

Market commentary last year suggested that a significant recession was a foregone conclusion due to the extent of interest rate hikes. While we still believe that New Zealand is in for a challenging period, some big markets like the US are proving surprisingly resilient and there is increasing talk of avoiding recession altogether.

Inflation has fallen from 9.1% to 4.0% in the US (and is expected to fall to 3% in the next month). While unemployment is low, the consumer spending is strong, and interest rates are having limited impact on family budgets (due to 30-year fixed mortgage rates).



Source: Bloomberg

We are not out of the woods yet, however. Periods of rapidly rising interest rates seldom occur without consequences. But the debate has shifted from last year's fears of prolonged stagflation.

With different risks and economic drivers in focus, we often get asked: 'what is the go-to asset class for 2023 and 2024?' Will it be bonds with interest rates starting to fall? Or the share market if inflation really is under control? Or gold if inflation surprises and stays stubbornly high?

Protecting yourself from an unpredictable world

Don't search for a 'silver bullet' investment that will shoot the lights out this year. Instead, investors need to focus on building portfolios that can perform well over the long-term in a range of different economic scenarios, regardless of the path that markets take in the short term.

As we have seen in recent years – with pandemics, wars, high inflation, Brexit and low inflation – the unexpected is constantly happening in markets. Investors need to make sure their portfolios are future proofed for whatever is thrown at them in the next 20 years and more, both before and during retirement.

How will your portfolio perform in a period of prolonged inflation like we had in the 1970s? How will it perform in periods of low inflation and low growth? What about in an environment of sustained economic and productivity growth when real incomes are rising, and you need your retirement income to do the same?

Different asset classes perform different roles

This is why portfolios have a range of different asset classes (cash, bonds, shares, and property) in a range of different geographies.

If, as we have seen recently, inflation and interest rates start to come down, what does that mean for investors? Investors in term deposits may have locked in an okay rate for one year, but they may find themselves locking in a much lower rate in a year's time (we call this reinvestment risk). If you had invested in corporate or government bonds instead, you could have locked in a higher yield for five or more years – and you will potentially see the value of your bonds rise materially in value if yields fall.

On the flip side, if inflation doesn't come down and stays high for a prolonged period, investors need assets in their portfolios that will outstrip the impacts of inflation. In this scenario, cash and fixed income investments are likely to see their value go backwards, whereas property or share market investments are more likely to outstrip and offset the impact of this inflation over the long term.

The point here is not to try and guess what may play out. It is to understand that over the years a lot of unexpected events will occur – the last three years are proof of that. A diversified portfolio with a range of growth and income assets is more likely to help investors achieve their goals. Investors always need to balance offence and defence.

Refocused tech is back on top

Matt Peek, Portfolio Manager, New Zealand Equities

Investments in technology companies Xero, Serko, and Vista underpinned a strong quarter for returns off the back of more profit-focused performance.

The three software companies in our portfolio all delivered strong returns:

- business travel software provider Serko (+57% in the quarter)
- small business platform Xero (+33%, and on the back of +27% in the March quarter), and
- cinema software player Vista (+24%).

We have seen a rebound in retirement village operators Ryman (+25%) and Summerset (+9%). This rebound is likely due to the New Zealand housing market decline being long in the tooth, migration increasing, and the Reserve Bank of New Zealand largely finished with its cycle of hiking interest rates.

Healthcare remains a defensive sector, although it dragged on performance during the quarter. Fisher & Paykel Healthcare (-7%) is taking longer to restore profit margins towards long-term targets due to cost pressures. EBOS (-21%) was dealt a surprising blow after competitor Sigma bid aggressively to win the contract to supply Chemist Warehouse's pharmaceuticals in Australia from mid-2024.

We continue to see economically exposed companies struggle, with both earnings and share prices coming under pressure. Key examples are domestically focused consumer-facing companies that the fund does not own shares in, such as My Food Bag, Briscoes, Kathmandu, and KFC and Pizza Hut franchisee Restaurant Brands. While they are less acutely exposed, the performance of Mainfreight (+3% in the quarter) and Freightways (-12%) remain muted due to subdued freight volumes and cost pressures.

For these reasons, we selectively increased the defensive positions where the valuation is attractive, such as participating in the Infratil equity raising. We're also on the lookout for opportunities to add to quality cyclical investments with attractive longer-term growth prospects that have been sold off, such as Vulcan Steel. We remain cautious given the tricky economic landscape.

Our tech trio was a strong driver of outperformance

First, these companies have structural growth drivers and the businesses are delivering relatively strong revenue growth. For example, Serko's revenue guidance for its 2024 fiscal year implies 39% growth at the midpoint, largely driven by growth in its partnership with global travel giant Booking.com.

Second, the companies are now more focused on profitability and cash flow. Xero's CEO has said she is seeking a 'better balance of growth and profitability'. Vista's new CEO is planning to remove unnecessary complexity from the business and accelerate the delivery of cash flows.

Third, in a reverse of the optimism in 2021, during 2022 many tech company valuations fell too far. This drop was due to concerns that growth was not profitable. The companies that are addressing these concerns have seen their valuations recover.

> ... we had been quietly confident the returns from our technology companies would improve in 2023.

Infratil has increased its ownership of One NZ

During May, Infratil purchased the other half of One NZ (formerly Vodafone NZ) it didn't own for $1.8 billion. This gives it full control and increases cash flows, which it can use for dividends and growth opportunities.

One NZ's management team have increased profit margins substantially through improved operations and are now taking market share in mobile. There is potential for higher margins through optimising mobile pricing along with ongoing efficiency gains.

Infratil raised $935 million of new equity to fund the acquisition and we participated, increasing our position size. The acquisition is sound and the equity raising was priced attractively (shares issued at $9.20 versus the prior price of just over $10).

Infratil delivered a return of +12% for the quarter.

Vulcan adds some steel to the portfolio

During the quarter there was both a departure and a During the quarter there was both a departure and a new addition for the portfolio.

As we discussed last quarter, we sold the fund's shares in Pushpay into the takeover offer for the company at $1.42, after fighting to get a higher offer for shareholders.

We added Vulcan Steel to the portfolio in May. Vulcan is the leading steel distribution and value-added processing player in New Zealand and Australia. It is an impressive business in an unexciting industry.

We have been following Vulcan since its listing in late 2021. While the company may have flown under the radar as a private company, it has a strong track record for delivering on its growth ambitions. The recent share price weakness provided the opportunity to initiate a position for the fund.

Vulcan has a unique business model for its industry

Vulcan has a differentiated business model built on leading customer service in an industry where customer service is typically poor. Vulcan's 'delivery in full and on time' metrics are far ahead of competitors, which enables it to charge a premium for its reliability. This translates to higher profit margins and returns on capital invested.

Vulcan has a strong performance culture, and a business-owner mentality cascades throughout the organisation due to its flat organisational structure and de-centralised management approach. Team members on the floor also participate in the business's success through profit share incentives.

Vulcan has grown to command a leading position in its markets

From its beginnings in the 1990s, Vulcan has grown to command the leading position in the New Zealand steel distribution market. It is earlier on its growth journey in Australia and still has ample runway to take market share in the fragmented Australian market from a very low base using its proven strategy. And it is succeeding: it is already larger in Australia than New Zealand.

It has also more recently moved into aluminium by acquiring Ullrich Aluminium, the leading trans Tasman player in this space, at a reasonable valuation. This increases the company's growth opportunities moving forwards in a variety of ways.

Some strong performers while new opportunities lie ahead

Robbie Urquhart, Senior Portfolio Manager, Australian Equities

A strong Q2 for the Australian Fund masked a wide dispersion of returns across our portfolio companies. This has provided us with some attractive investment opportunities within the portfolio.

Q2 performance across the broader Australian market was mixed. Information technology was by far the strongest sector, rising +21% in the period. Constituent companies generally delivered strong trading updates. The sector was further helped by positive investor sentiment to companies deemed to benefit from artificial intelligence (AI) as well as modestly improving global inflation data.

In contrast, the worst performing sector, Healthcare (-3.2%), was weighed down by bellwether CSL's (-3.8%) profit downgrade, and some poor updates from other sector constituents. Softer economic data out of China weighed on the materials sector (-2.6%). In addition, having been relatively cautious in its fight against inflation, the Reserve Bank of Australia (RBA) became more hawkish, lifting interest rates by 0.5% across the last 2 months of the quarter. This weighed on companies with a focus on the domestic Australian economy.

Against this backdrop we were pleased with the overall performance of our portfolio.

AI wasn't the only driver for information technology share prices rising

In the past few months, it seems that ChatGPT and AI is all that business journalists have been writing about. This attention has seen a sharp increase in investor appetite for companies deemed to benefit from the rise of AI. This has likely contributed to the performance of our technology-focused portfolio companies as well.

But many of our technology companies are also performing well operationally. Strong reported revenue growth has been supported by a disciplined focus on costs (a recent, welcome development for tech businesses). This has resulted in a strong increase in underlying profitability which has been taken well by investors.

In the past few months, it seems that ChatGPT and AI is all that business journalists have been writing about.

Fineos is growing strongly

Life insurance claims software provider Fineos (+66% in AUD in Q2) has had a busy period of announcements. It has reported strong revenue growth so far in 2023 from expansion within its existing client base. It has also converted customers who use legacy versions of its software to a cloud-based version, which incrementally adds to its revenues.

Most importantly, after a few years of having its sales cycle impacted by the pandemic, Fineos has also announced new multi-year landmark contracts with two large, new North American customers. And Fineos' cost-cutting initiatives are on track to meaningfully improve its cash flows.

Xero has experienced strong revenue growth

Accounting software provider Xero's (+33%) FY23 financial results in May demonstrated a strong growth in revenue (+28%) during the year. This included a re-acceleration in subscriber growth in the UK, a key growth market for the company.

Like Fineos, Xero has also undertaken a broad cost-cutting initiative. It is actively prioritising profitability and cash generation over its past focus on reinvesting every spare cent into growth initiatives.

NEXTDC is benefiting from the rising demand for data storage

NEXTDC (+21%) clearly benefits from the rise of generative AI, which will likely require vastly increased data storage and computing power to be housed in data centres like those built by NEXTDC.

During Q2, NEXTDC announced its largest level of incremental customer contract wins in its history. It announced a 43% increase in the total level of its facilities that were contracted out. The majority of this increase has been sold at its data centre site in Sydney (S3).

The increased growth in global demand for data-centre capacity also saw NEXTDC raise 618m AUD in new equity in May. It will use this new equity to accelerate its expansion in Australia and international markets, including Malaysia and New Zealand.

How bad are profit downgrades? The devil lies in the detail!

Some of our portfolio companies haven't fared as well in Q2. A handful of companies announced disappointing trading updates that affected their returns.

In the case of oOH!Media (-27.4%) and CSL's (-3.8%), the reasons for their downgrades lie largely out of the control of management. The headwinds facing them will abate and we think the growth outlook for both companies is sound.

oOH!Media is likely to recover

After rising strongly during Q1, oOHMedia!'s share price fell sharply in May in what we view as an overreaction to a trading update early in the month. This update indicated that March quarter revenue was up by +3% on the year before and that the June quarter to that date was slightly ahead of 2022. At the company's AGM a week later, the June quarter was reported as running +3% ahead of last year, with May and June pacing at double-digit growth. This was a meaningful offset to April's -10% decline which was a key source of the downgrade. Obvious current headwinds include less government spending this year compared to last year's spending which was inflated by advertising around COVID-19 and the Federal election.

Near term, the advertising market has showed signs of softening as the impact of higher interest rates continues to hurt consumer spending. Within this, we think oOH!Media is doing a credible job managing what it can control. This includes securing the strategically important new Sydney Metro (City and Southwest) contract in late June.

Over the longer term, its future is bright. We think out-of-home advertising should continue to take share from other media formats. This will be driven by:

- ongoing digitisation of its asset base
- increasingly sophisticated audience measurement giving advertisers confidence in the return on their spend, and
- greater programmatic trading of out-of-home inventory giving advertisers more flexibility.

CSL is heading in the right direction even if recovery is slower

In CSL's case, it announced in June that currency headwinds would detract from its FY23 financial results. Excluding the currency impact, it guided to the top end of its previous profit range. It also dampened down expectations for FY24 profit growth noting it expects to still grow profits between a healthy 13% to 18%. Although this was below market expectations, the currency headwinds are clearly out of CSL's control. The slower than expected recovery in post-pandemic profit margins is also somewhat out of management's control.

Overall, the CSL management team is performing well. Throughout the pandemic they continued investing in additional manufacturing capacity and improving the efficiency of their operations – essentially widening the moat of the business. They have given the business a great platform to be successful.

Even if it is a bit slower than the market would like, CSL's profit margin recovery and earnings growth is heading in the right direction.

Domino's has had another disappointing earnings downgrade

In contrast, in Domino's (-6.9%) case, another disappointing earnings downgrade in June followed on from the profit warning delivered in February that we discussed in the March quarterly update. The inflationary cost pressures and Domino's response to these pressures such as increasing menu pricing and introducing delivery fee surcharges, continues to weigh on its sales and profit margins.

The management team has taken several steps to address these challenges. However, the trading update in June highlighted that, while it has made progress, these measures are yet to bear any meaningful fruit. Domino's announced that it is taking further steps to reduce costs and improve profitability during FY24. It has also decided to close a handful of unprofitable stores across its network.

We believe that Domino's results are a function of a very unusual operating environment.

We recognise that management are working hard to address their errors around pricing and performance. And we think the shares are attractively priced, should management achieve their objectives. Hence, we have topped up our shareholding in the business. That said, for us to add more meaningfully to our position, we would like to see evidence of management delivering on these objectives.

Dispersion in share price performance presents investors with opportunities

Within the healthcare sector, we exited our Cochlear shareholding in April, and then in June, we increased our Resmed weighting and topped up our CSL holding after their shares fell following their trading update. Cochlear's earnings had rebounded strongly after the pandemic. Its share price had risen +37% since we added it to the portfolio in January 2022 and was looking expensive to us even though we still like the business. Resmed and CSL in contrast are also high-quality businesses with bright prospects. However, they are more attractively priced, so we've been happy to add to these two positions.

We have trimmed (or in the case of Woolworths, modestly reduced) our positioning in a handful of portfolio companies where the share prices have moved closer to fair value. These companies include Wisetech, REA and Brambles.

In contrast we topped up our oOHMedia! and Domino's shareholdings after their trading updates.

Lastly, we participated in the equity raisings (at what we thought were attractive valuations) undertaken by NEXTDC and AUB Group during the quarter.

Ongoing rebound in markets driven by corporate earnings

Sam Dickie, Senior Portfolio Manager, Select International Equities

Macro trends come and go, but corporate earnings are the most important driver of stock price performance in the medium and long term.

The US reporting season closed with 78% of companies beating earnings expectations. This is the best upside earnings surprise (off a subdued base) in several quarters. The European reporting season was a little more subdued, with 61% beating earnings expectations. This helps explain the ongoing underperformance of European equities (+10% for calendar year to date) vs US equities (+17% calendar year to date).

US big tech had another strong quarter, with the Nasdaq up +15% and MAGMNA (equal weighted basket of Microsoft, Apple, Google, Meta, Nvidia and Amazon) +25% for the quarter. A small proportion of companies drives the majority of index returns over the long term, and our process is designed to find these stocks. However, when returns become concentrated like they have been recently, risk also increases. So, with this backdrop, we have been taking profits in our big tech names and broadening our portfolio exposure further.

Portfolio update

Alibaba (-19%) and Tencent (-13%) were weak alongside the wider Chinese market, as the expected economic recovery post re-opening has not yet materialised. The Chinese 'Golden Dragon' index fell -10% during the quarter as key economic indicators continued to show signs of weakness. Ecommerce companies, such as Alibaba, were hit particularly hard as the expected reopening boom has not played out.

Alphabet (+15%) rallied following its I/O developer conference held in early May. At the conference, Google demonstrated how it is incorporating Generative AI (GAI) into key products like Search, easing concerns that the company is falling behind Microsoft in terms of AI innovation. The shares fell modestly in June (-3%) as market sentiment soured on Google's ability to maintain advertising dominance and profitability in the era of GAI and conversational search. While it is early days, the company is in a good position to win in the GAI era due to the ubiquity of Google Search, Google's trove of first-party data, and its AI research and investment capabilities.

Amazon (+26%) reported mixed earnings. Cloud computing platform AWS reported better revenue and earnings than expected. However, management guidance for the upcoming quarter was weaker than expected. AWS headwinds in recent quarters have been driven by tightening IT budgets and customers rationalising spend through optimisation. We think these headwinds are abating and AWS' growth should re-accelerate later in the year as the structural trend toward cloud computing continues. Over the past two years, Amazon has made major investments into its logistics infrastructure. This will begin to pay off as the company grows into the expanded footprint and its profit margins go up. Amazon's advertising business was a star in the quarter, growing +23%. A long growth runway lies ahead for advertising as the business continues penetrating their merchant base.

Amazon's advertising business was a star in the quarter, growing +23%.

The largest discount retailer in the United States, Dollar General (-19%), declined on the back of a disappointing quarterly update where the company lowered full year earnings guidance. Concerns have centred around increased competition (from Walmart and Family Dollar) and potential underinvestment in labour. Dollar General disclosed US$100mn of additional labour spend to add 8 extra employee hours per store each week. Our view is that this investment in increased labour hours may rise. However, we think there will be a return on that investment. And we think the market had already priced in a more adverse outcome than US$100m.

Icon (+17%), a leading clinical research outsourcing company, had a tumultuous quarter, down -14% at one point before ending the quarter strongly. The pharmaceutical services industry has been facing slowing growth from their small biotech customers over the last 18 months. Many of these biotech customers rely on external funding (either from the venture capital industry or via public listings) to run clinical trials for new drugs, and this funding has come back to more normal levels from the heady levels seen during 2020 and 2021. We think the impact and duration of the slow-down should be limited and that the secular growth drivers for pharmaceutical spending on research and development are still intact. We took advantage of the price weakness to add to our position. In the last couple of weeks, Icon's management have shifted to a more optimistic tone around biotech demand.

Meta is well positioned to continue to take global advertising market share.

Meta (+35%) had a strong earnings report that saw its shares bounce +11% in April. Strength continued through the rest of the quarter as spending on digital advertising re accelerates. Meta is well positioned to continue to take global advertising market share as AI improves return on investment for advertisers.

Portfolio activity: We have added three new holdings to the portfolio.

Danaher

Danaher is a leading player in the Lifesciences and Diagnostics industries where it provides its customers with the cutting-edge tools to help them to diagnose disease and discover and manufacture new drug therapies to treat those diseases.

Why do we own it?
An aging population and growing healthcare spend are driving the need for increased innovation in the diagnosis and treatment of chronic disease. With a leading portfolio of tools and services in these end markets, Danaher is well-positioned to benefit from these trends.

Driven by a well-renowned culture of continuous improvement and investment, we expect Danaher to grow its market share as it becomes an increasingly essential partner to its customers.

MSCI

MSCI is a leading provider of indices, benchmarks, index data and analytics tools for the financial industry, and is particularly known for its global and emerging market indices. Customers use the company's indices to define the investment universe for their products, benchmark their performance, and construct exchange traded funds (ETFs) that will track an existing index or thematic. The company serves over 6.6k clients in 95 countries and MSCI has $13.7tn in assets-under-management benchmarked to its various indices.

Why do we own it?
MSCI has attractive growth tailwinds such as the growth of ETFs and increased focus on ESG and climate change. MSCI is the most innovative index provider and has market-leading products to capture each of these tailwinds. MSCI's wide moat is driven by its strong brand, scale and switching costs which all result in high customer retention rates. MSCI has a long-tenured management team with material ownership in the business, aligning them well with shareholders.

UnitedHealth Group

UnitedHealth Group was originally a health insurance company and has expanded to become the leading healthcare services company in the United States, encompassing insurance, provision of healthcare and other related businesses including pharmacy and technology services.

Why do we own it?
UnitedHealth Group is well positioned to benefit from three key trends in healthcare:

- an aging population and the increased outsourcing of this care to providers such as UnitedHealth
- a shift towards value-based care, and
- the leveraging of data and analytics to drive efficiency.

UnitedHealth Group has a wide moat driven by a combination of local scale, supported by large national infrastructure and a vertically integrated model. This should allow UnitedHealth Group to continue gaining market share across its business.

Expectations for a slowing global economy could create a tailwind for the funds

David McLeish, Senior Portfolio Manager, New Zealand Cash & Fixed Interest

Resilient global economic data caused market expectations for future interest rates to rise this quarter. In turn, this pushed New Zealand fixed interest asset values lower. Somewhat offsetting this was the healthy level of income these assets are now generating. Looking ahead, we expect economic activity and the rate of inflation to slow further, which should act as a tailwind for fixed interest asset returns in the second half of this year.

The Fisher Institutional New Zealand Fixed Interest Fund fell by -0.2% this quarter, outperforming its benchmark by +0.4%. The Fisher Institutional New Zealand Cash Fund rose 1.4%, which was 0.1% ahead of its benchmark.

The New Zealand economy is likely to remain in a funk this year

The long and variable lag between rising interest rates and the negative impact this has on economic activity suggests to us that the economy will struggle to grow in the second half of this year. That should help push inflation lower, towards the upper end of the Reserve Bank of New Zealand's (RBNZ's) 1–3% target.

Our New Zealand business cycle model suggests the economy is already in the doldrums, with most indicators below their long-run average reading and continuing to deteriorate. The labour market remains the lone shining light with jobs filled still running at 3%+ annual growth. However, more recent, forward-looking employment indicators suggest this lagging indicator is also starting to turn.

With interest rates now at punitive levels, we expect business investment and consumer spending to reduce more in the months ahead.

Disinflation looks set to continue

Regular readers might remember, it was this time last year that we first suggested global inflationary pressures were beginning to ease. We believed that Covid-induced supply factors were the key inflationary drivers at the time, and not sustainable excess demand. As supply chains healed and commodity prices fell, the alleviation of these cost–push factors have driven the first round of global disinflation.

Our latest research suggests more disinflation ahead and this time it could be services led – as depleted household savings, cooling labour markets, and high interest rates curb discretionary spending. Looking into 2024 and beyond, we also believe the rapid adoption of Generative Artificial Intelligence is likely to result in a significant boost in productivity, which has the potential to be a large disinflationary force. This is something we are watching very closely.

That said, on a purely domestic front, we are not yet convinced that the idiosyncratic elements of New Zealand's inflationary picture (weather-related rebuild, recent minimum-wage boost, tight labour market, and strong migration) will allow the Consumer Price Index to return to within the RBNZ's target range before the middle of next year.

Falling inflation and slower growth are bullish for bonds

The RBNZ may still have one or even two 0.25% hikes left to administer. But we are close to the end of this hiking cycle. Timing the eventual end of this cycle is not something we believe can be precisely predicted. So, we have begun adding back duration (i.e. interest rate sensitivity) into our fixed interest fund – from a previous underweight position. The attractiveness of short-term interest rates, given the deeply inverted yield curve, has us maintaining our mild overweight duration stance in the cash fund.

Earlier in the quarter, and in the previous quarter, we selectively reduced our corporate bond exposure. In our view, the tightness of some credit spreads didn't fairly reflect our deteriorating economic outlook. Since then, the credit spreads for some of our more favoured borrowers in interest rate sensitive industries (such as banks and aged-care providers) have widened. So, more recently, we have been adding this exposure back into both portfolios.

A solid month to finish the quarter for infrastructure equities

Sam Dickie, Senior Portfolio Manager, Property & Infrastructure Fund

The Property & Infrastructure Fund finished the quarter up +3.1%, outperforming its benchmark index which was up +1.5%.

Global infrastructure equities were up +3.0% in the month of June and NZ property was up +3.7%. This 1-month performance drove a rebound in what was previously a sluggish quarter for global infrastructure and regional property equities. Global infrastructure equities finished flat for the quarter, while Australasian property finished up +3%.

Reduced fear of recession, disinflation and the resultant pausing, or at least a slowing, in the pace of central bank rate rises have been helpful drivers for markets.

However, for Property & Infrastructure as for equities generally, corporate earnings are the most important driver of stock price performance in the medium and long term. And most importantly, it is forward looking earnings expectations that drive stock prices. Year ahead earnings expectations are now getting upgraded, and in some cases sharply. The risk of recession seems to have receded for now. Companies have been cutting costs and demand is still hanging in there. Global infrastructure, global airports and US Industrials have all had earnings upgrades in the last quarter. Even the Australasian property sector has seen earnings and dividend expectations stabilise.

Global infrastructure, global airports and US Industrials have all had earnings upgrades in the last quarter.

Portfolio update

Auckland Airport

Auckland Airport (+2%) announced $5.6 billion of investment over a 10-year plan, which also included capital spending and airline pricing for the next regulatory period ('PSE 4', covering 2023 to 2027).

To earn a 'fair' return on investment, airport charges will increase 20% per year over the next 4 years. Auckland Airport considers a fair return to be 8.7%. The Commerce Commission believes 6.7% to be more appropriate and will complete a pricing review in early 2024 which may result in a revision to announced pricing. The level of investment will strain Auckland Airport's balance sheet, with the dividend payout target being reduced recently, and there is a prospect of a future equity raise.

Finally, Auckland Council announced an intention to sell down 7% of its total 18% stake in the airport, which should lead to an increased weight in equity indices for Auckland Airport.

Equinix

Equinix (+9%) hosted its bi-annual investor day in June. Revenue growth is expected to remain higher for longer, albeit margins will be slightly lower than expected.

Equinix is investing more to support growth beyond 2027 (investment targets were 10% above expectations). Their growth targets compare favourably to datacentre and telecom tower peers, with cash flow per share growth of 7% to 10% and dividend per share growth of 10%+, whereas peers are typically growing at 5% or less annually.

In May, Equinix announced first quarter results, which showed their ability to pass on elevated power prices to customers – a key point of controversy in the market.

Infratil

Infratil (+12%) reported its result in May, which was in line with expectations. Canberra Data Centres 'CDC' reported 33% earnings growth but noted delays in building a new Melbourne site. One NZ (formerly Vodafone New Zealand) reported 11% earnings growth, higher than expected, supported by operational efficiency initiatives.

In June, Infratil purchased the remaining 49.9% of One NZ that it didn't own for $1.8 billion, a fair price for a great asset. By taking full control, Infratil will have more decision-making freedom and will receive higher cash income, supporting dividend growth and further investment in CDC and Longroad Energy. The acquisition was funded with debt and a

$935 million equity raise, priced at a 9% discount. We participated in the capital raise and increased our position size due to the attractive discount on offer.

US rail investments

Our US rail investments Norfolk Southern (+7%) and Union Pacific (+2%) rounded out a volatile quarter with a solid month. The rail companies had a difficult few months to start the year. This was driven by the combination of declining volumes, a weakening in the intermodal pricing outlook (around 40% of revenues) and rising concerns about regulatory intervention.

We upgraded our position in Norfolk Southern during the quarter as the volume outlook was stabilising and the downwards pressure on intermodal pricing from a weak trucking market was also stabilising. The volume disruption from the East Palestine rail derailment and subsequent impingement on efficiency in that region is largely behind us.

European airports

Zurich Airport (+13%) and Vienna Airport (+23%), both Lufthansa hub airports, performed strongly. Their traffic performance closed the gap with peers such as Groupe ADP (Paris Airports).

Lufthansa had been slower than peers to restore capacity given its weak balance sheet. In 2022, Zurich and Vienna reported traffic 72% and 75% of 2019 levels respectively, compared to 80% at Groupe ADP (Paris airports, Air France-KLM hub).

In the year to date (May), Zurich and Vienna reported traffic 86% and 88% of 2019 levels, compared to 88% at Groupe ADP. Groupe ADP (month: -5.4%, quarter: +2.2%) sold off in June due to press reports about a new French government tax framework for concessions (toll roads, airports, railways, hydro dam operators). ADP's regulatory framework should allow for the recovery of any increased tax burden. In April, Groupe ADP reported positive momentum in its retail business as it rolls out a new 'Extime' strategy.

Market Movements

as at 30 June 2023

Bond Indices	Closing Values	Changes over: 3 Mths %	6 Mths %	12 Mths %
S&P Global LargeMidCap ($NZ)	N/A	8.7	18.0	18.7
USA - S & P 500	9560	8.7	16.9	19.6
USA - Nasdaq	16658	13.1	32.3	26.1
Japan - Topix	3805	14.4	22.7	25.7
UK - FTSE100	7905	-0.3	3.2	9.1
Germany - DAX	16148	3.3	16.0	26.3
France - CAC40	22306	3.5	17.4	28.9
HK - Hang Seng	61059	-6.0	-2.7	-10.6
Australia - S & P 200	89032	1.0	4.5	14.8
NZ-S&P/NZX 50 Gross Index (inc imp credits)	14857	0.4	4.3	10.6
Market Volatility - VIX	13.6	-27.3	-37.3	-52.7

Property		%	%	%
S&P/NZX All Real Estate (inc imp credits)	1695.0	3.3	5.3	-0.1
S&P Global Infrastructure Index (70% Hedged NZD)	6756.6	0.0	3.8	2.8

Ten Year Bonds	%	Yield Changes		
USA	3.81	0.33	-0.07	0.83
Japan	0.39	0.07	-0.03	0.17
United Kingdom	4.41	0.89	0.75	2.10
Australia	4.02	0.72	-0.03	0.36
New Zealand	4.66	0.47	0.21	0.80

90-Day Interest Rates	%	Yield Changes		
USA	5.43	0.58	1.01	3.71
Japan	0.07	0.00	0.01	0.00
United Kingdom	5.39	0.97	1.52	3.72
Australia	4.36	0.66	1.09	2.52
New Zealand	5.71	0.48	1.06	2.85

Market Movements

as at 30 June 2023

Bond Indices	Closing Values	Changes over:		
		3 Mths %	6 Mths %	12 Mths %
S&P/NZX Bank Bills 90-Day	771.84	1.30	2.43	4.11
Bloomberg Global Aggregate Index (Hedged NZD)	N/A	0.06	2.73	-0.26
Bloomberg NZBond Infl 0+ Yr Index	5615.32	-0.73	3.33	5.73
Bloomberg NZBond Composite 0+ Yr Index	1476.11	-0.58	1.81	0.47

Hedge Funds & Commodities		%	%	%
HFRX Global Hedge Fund Index (USD)	1376	0.6	0.6	1.3
DJ-UBS Commodity Index Total Return	227	-2.6	-7.8	-9.6
Gold (US$/ounce)	1921.10	-2.4	5.6	6.5
Oil (US$/barrel)	74.90	-5.4	-9.6	-37.5

Currencies		%	%	%
NZD / USD	0.6127	-2.1	-3.1	-1.5
NZD / EUR	0.5615	-2.5	-5.2	-5.6
NZD / GBP	0.4819	-4.8	-8.3	-5.9
NZD / AUD	0.9204	-1.5	-1.3	1.8
NZD / YEN	88.55	6.3	6.1	4.8
Trade Weighted Index	70.82	-0.6	-2.2	0.7

*Total Return Indices. Indices are net of offshore tax.
Source: Thomson Reuters Datastream

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