Contact Asset Management

INSIGHTS

APRIL 2024

CONTACT ASSET MANAGEMENT

Long Term Tailwinds – Taking Advantage of Local Opportunities.

We are currently witnessing an unusual situation in Australian Equities markets. Markets are strong, at the end of March, the S&P/ASX 300 Accumulation Index hit a new record high. Yet, this is occurring against a continued wave of negative investor sentiment.

We are long-term investors at Contact Asset Management, and we see the importance of staying the course. Our investment process is vigorous and detailed, and has been honed for generations. Our stock selection is driven from the Bottom-Up, however we believe that it is always important to have an eye on the macro and what is diving the direction of the economy.

We remain bullish on Australian Equities for the long-term. Our market is resilient and we have several structural tailwinds in Australia that are often underappreciated. We've discussed these tailwinds before but are now even more optimistic that these themes will reward the long-term investor.

Short-Term Focus on Inflation, Is it Too Much?

It's fair to say that Central Banks globally are trying to exert more control over inflation than they have for many years. Having raised rates aggressively from mid-2022, we believe we are now at peak levels for this cycle. The consensus view from economists globally is that the next move on rates is down from here. Well at least we're hoping!

The major concern is that this resilient inflation environment is continuing. The direction of global inflation is not as clear cut as it was, and it is sending economists into a spin on when and how many rate cuts they believe will occur this year. At one point, the US market was pricing in 7 rate cuts in 2024. Now, the market is expecting only two. In Australia, the expectation is that in the next year the RBA will cut rates twice, taking our official cash rate to 3.85%. It wasn't that long ago that the expectation was that our cash rate would be closer to 3.35% by year's end. The current RBA cash rate is 4.35%.

Despite the less dovish stance on rate cut expectations, the more important factor to focus on as an investor is that reported inflation numbers continue to trend lower and that the initial rate rises implemented over 2022-2023 are actually working. Inflation is significantly lower today than it was a year ago. Rate cuts will follow at some point, we don't know when and it is impossible to try and predict this outcome. The unnecessary and short-term focus being placed on when the first cut will be is creating almost daily volatility in equity markets. We believe that investors should stay focused on the long-term and ignore this current wave of noise.

Eye's Up Investing – Looking a bit Further Out.

This resilient inflation environment is having an impact on the equity investment cycle. Its very volatile and unpredictable. We aren't focused on when and how many rate cuts will occur this year, but rather remain focused on picking stocks. We do not pretend to be economists. Short term, we remain patient and quality-focused on stock specific opportunities.

We do, however, keep track of the longer-term macro environment and consider where we think tailwinds and themes will emerge. These themes are not always right in front of us, sometimes they a little further away, but for investors with time on our side we can afford to look out, be patient and take a longer-term view.

This is certainly a very interesting and exciting time for Australian equity markets. Our market has always been very resilient and despite the short-term noise surrounding inflation, investors will do well here in Australia over the cycle. Looking forward, we are focused on several structural tailwinds in Australia that are often underappreciated by investors. We've discussed these tailwinds before but are now even more optimistic that we will be rewarded for following these themes. Below we discuss Superannuation, Population Growth and Resources, with the outcomes of these themes putting the Australian Equity market in a superior position to others around the world.

Superannuation

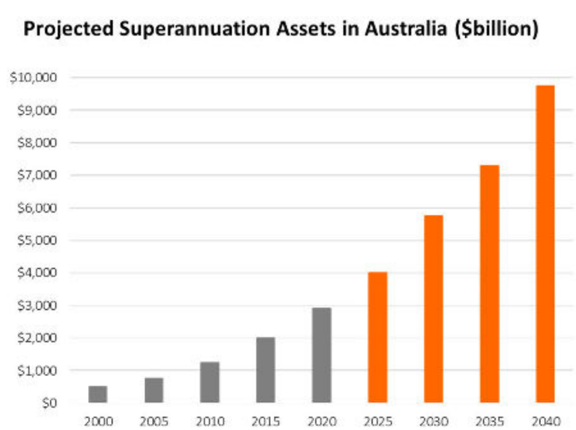
The Superannuation Guarantee (Administration) Act came into effect on 1 July 1992, requiring employers to contribute to a super fund on behalf of their employees. The Superannuation Contribution rate was only 3.0% initially and the pool of accumulated superannuation savings was approximately $150 billion. Thirty-two years on, the contribution rate is now 11%. This will increase to 11.5% on 1 July 2024 and then rise again to 12.0% in 2025.

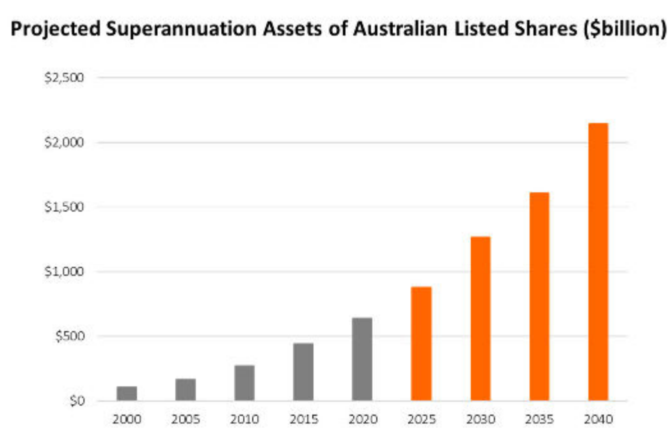
The increase in the Australian Superannuation industry has been profound. There is now more than $3 trillion currently invested as Superannuation assets in Australia. More importantly, the expected growth of these assets is enormous. According to ASFA Superannuation Statistics (May 2023), it is projected that super assets in Australia will be worth almost $10 trillion by 2040.

As long-term investors, where we see these forecasts becoming interesting is where this capital is expected to be allocated. A typical Asset Allocation to Australian Listed Shares currently represents approximately 25%. With many Australians having far more of their wealth directed to equities than this, following years of investing and being the beneficiaries of compounding. However, if we assume that 25% of the forecast $10 trillion of super assets are allocated into Australian equities, we will see a staggering $2.5 trillion invested into our stock market. To put the scale of these potential inflows of capital into perspective, the market cap of the S&P/ASX All Ordinaries index as at 31 January 2024 was $2.6 trillion. This wave of demand will be a significant tailwind to Australian Equities.

Area of Focus 1

Superannuation





Source: ASFA Superannuation Statistics May 2023, Treasury MARIA model and Cooper Review. APRA March Quarter 2023.

Population Growth

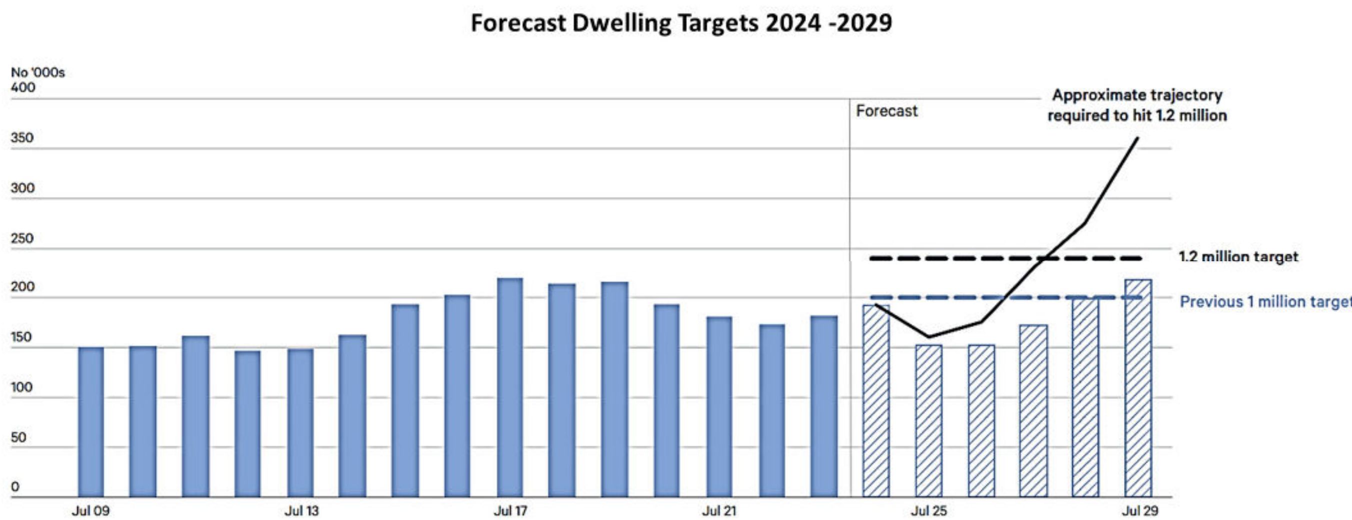
Population growth is another positive driver for the Australian economy, the property sector and in turn equity markets. Net migration into Australia is forecast to remain at record levels. The arrival of foreign workers and international students will be a welcome relief for some businesses trying to address labour shortages. However, this could put further strain on the housing sector as demand quickly outstrips supply.

The chart below shows the historical dwelling completions in Australia (dark blue bars), and the forecast completions (in light blue). The black line is an indication of how many dwellings Australia actually needs to build each year to achieve the 1.2

million target over the next 6 years. There is a substantial gap between supply and demand of residential property in Australia. If Australia can successfully meet this demand, it will underpin earnings growth for several sectors, notably builders, real estate, hardware and logistics.

Area of Focus 2

Population Growth



Source: ABS, Oxford Economics September 2023. Mirvac living sector investor day 20

Resources

We have been positive on Australian resource stocks for many years. More recently, the energy transition has led to a significant increase in the demand for basic commodities and critical minerals. We have been interested in the energy transition, the expected speed of delivery and the impact it is having on countries in reaching targets.

Japan is an interesting case study. There is a newfound confidence in Japan, which. is highlighted by the outperformance of the Nikkei Index after such a long period of cheap equity valuations. This has been aided by recent corporate reforms as well as investment flows diverted from a battered Chinese stock market. In addition, the recent Woodside Energy (WDS.ASX) result showed a sale and purchase agreement with LNG Japan, for the sale of a 10% equity interest in the Scarborough Joint Venture. Post announcement, Japanese company JERA Co, one of the world's largest energy companies, acquired a further 15.1% participating interest in the Scarborough gas field development project. This recent confidence in Japan will be very good for Australia.

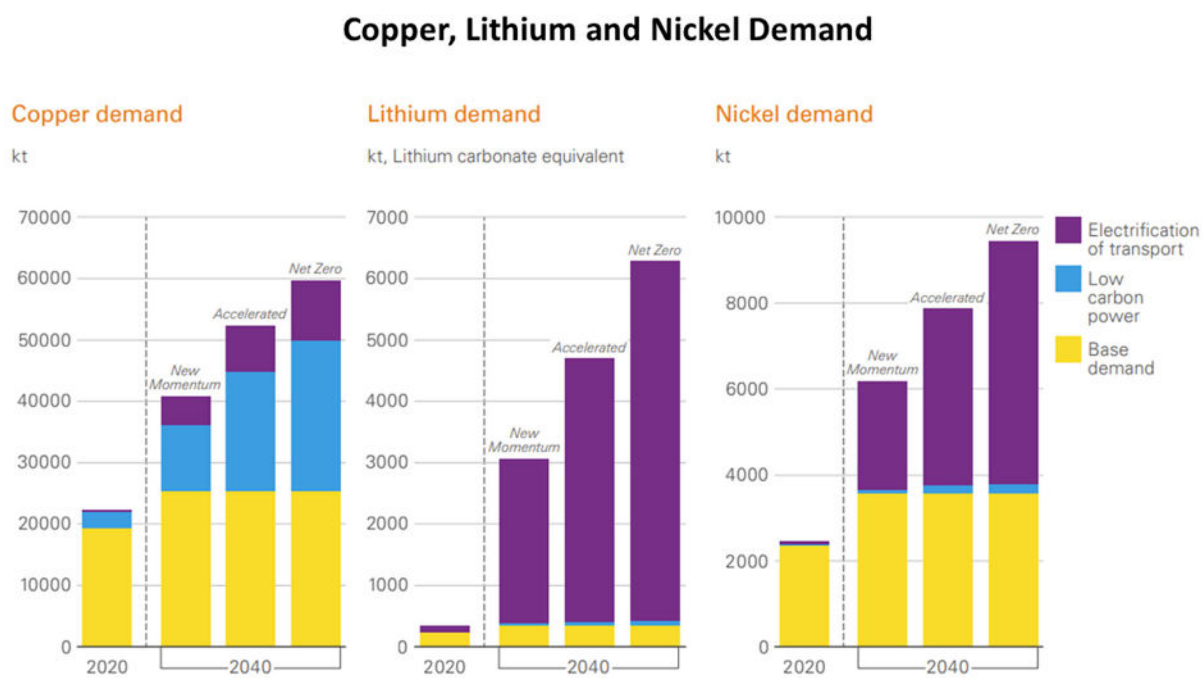
Despite Japan having bold renewable targets for 2030, they have failed to return to energy generation methods of Nuclear. Nuclear is still only 30% power generation from levels in 2011. Japan is focusing back on low-cost energy commodities such as Oil,Gas and Thermal Coal, but with a distinct focus on quality low carbon energy sources of Australian LNG and Australian Newc/6000 Thermal Coal. Pricing of domestic and commercial energy is still clearly very important to the Japanese government and the economy. This shift also ties in with a recent statement from Wood Mackenzie who believe that the global transition to net zero is now “unlikely until after 2070”. With quality, lower carbon Thermal Coal and LNG to play a big part in the make-up. In addition, according to Commodity Insights, their latest 2024 forecasts see the supply demand imbalance in Thermal Coal emerging in 2025, with medium and longer term prices for Newc/6000 to rise to US$150/t.

During reporting season, we heard from Australia-listed Lithium miners saying that they were confident they can weather the current weak prices by cutting spending and slowing the development of growth projects as they wait for higher demand to spur a rebound. Spodumene prices have finally rebounded after a 15-month plunge, with Lithium Chemicals prices following a similar trajectory. Unfortunately, we still believe that these commodities are very immature and will continue to be extremely volatile, especially post the latest news out of China suggesting sales of new-energy vehicles fell to 450k in February, a 9% drop on February 2023 (source: China Passenger Car Association’s (PCA)). Copper continues to trade on low levels amid lingering concerns of increased inventories in China coupled with weaker than expected demand, driven by a slowdown in battery consumption, mainly EV's. However, longer-term we are confident the supply issues will see the Copper price rally well above current levels.

The energy transition, despite it slowing from its initial pace, will lead to a significant increase in the demand for critical minerals. There are some very interesting and exciting statistics in regards to volume demand for 3 major commodities that will be needed if we are going to transition from traditional power sources to more wind and solar over the longer term. The increased demand for Copper, Lithium and Nickel is significant. For example, in the BP Energy Outlook 2023 Report, they forecast that to reach net zero by 2040, the globe will require 3 times as much copper that is in demand today. 4.5 times as much nickel and a staggering 20 times as much lithium.

Area of Focus 3

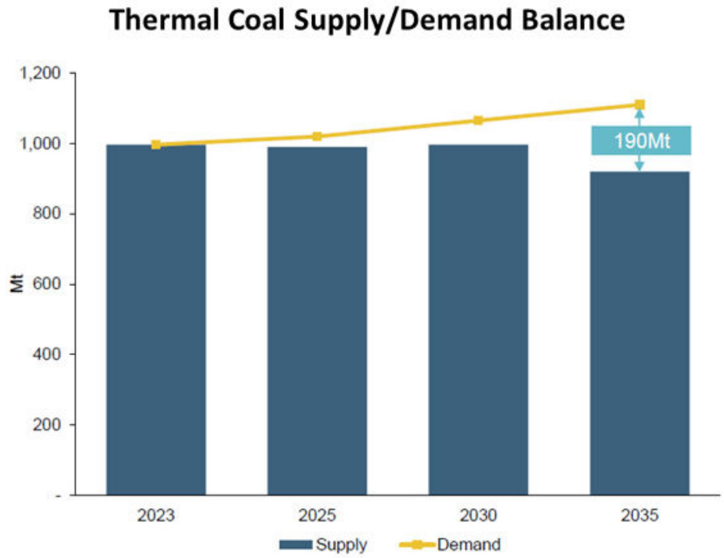
Resources - Materials and Energy Requirements



Source: BP Energy Outlook 2024

So too in Thermal Coal. This chart highlights the supply demand gap created in thermal coal from a lack of investment and production expansion. As Commodity Insights stated in their 2023 report "contrary to popular opinion thermal coal demand is not falling". From 2040 onwards, Commodity Insights forecast that there will be an additional 140Mt of thermal coal required each year across the globe for use in power generation.

Thermal Coal Supply/Demand



Source: BP Energy Outlook 2024

Summary

We believe investor sentiment is too short-term focused on equity markets. We invest for the long-term at Contact Asset Management, and we see the importance of staying the course. We continue to see numerous investment opportunities in our own backyard, driven by the structural tailwinds through Superannuation, Population Growth and Resources. We are very optimistic that these tailwinds, combined with Australia's entrepreneurial nous, will underpin a buoyant Australian Equities market in the long-term.

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