

**Sterling Clime
Conservative Portfolio
(SR0010)**

**Investment Summary
July 2021**



Praemium (SMA)

Market & Economic Commentary

The global economy has come a long way since the shock of the pandemic recession in March 2020, and yet the recovery of 2021 has so far been volatile and difficult to navigate. The remainder of the year could be even more difficult with the added stresses of increasing numbers of Delta-variant covid cases and potential central bank actions, which themselves are dependent on changing economic data signals.

Although forecasting is always difficult, we maintain the following set of assumptions:

- The COVID-19 recovery will continue in waves, with the US appearing to have turned the corner and Europe following closely behind, but with emerging markets lagging behind. Lockdowns and vaccinations have become largely determinative of the strength of the recovery. We assume that current vaccines will remain effective in preventing further waves of serious COVID-19 hospitalisation and death rates, even if further variants arise. Australia continues to lag in vaccination rates.
- US, European and Australian consumers are generally flush with cash, driving a jump in global demand. We expect this high (albeit selective) demand to support economies through year end.
- Supply and demand mismatches are expected to continue to be a headwind for growth through the rest of 2021 via supply chain problems, labour market mismatches, and inflationary pressures. Transitory inflation effects are expected to continue to influence global commodity prices into the second half of the year.
- Central banks of developed economies - the US, the UK, Euro area, Japan, and Australia – will probably remain on hold through to the end of 2021, although we expect uncertainty over the outlook for policy in 2022 and beyond to affect markets toward the end of this year.

We are cognisant of risks to these assumptions, such as lack of progress towards large-scale vaccinations, continued supply chain fragility forcing up prices, declines in business and consumer confidence, and a tipping over in production growth in key markets for Australian goods, such as China. Nevertheless, the restart of economic activity is real and broadening out from the US earlier in the year to Europe and Japan, both of which are benefiting from accelerated vaccination rollouts and the tailwinds from a global capex cycle.

In most developed countries, the threat of further nationwide lockdowns being imposed is receding – with Australia being the current notable exception. More difficult to quantify is the risk of a viral variant emerging that evades vaccines or threatens countries more substantially, such as by targeting children or by becoming more deadly, but this is not our baseline assumption.

Interestingly, house prices are booming in almost every major economy in the wake of the pandemic. Of the 40 countries covered by OECD data, 37 saw real house price growth in the first three months of the year. Low interest rates, accumulated savings during lockdowns, and a desire for more space as people work from home are all fuelling the trend. House price growth can be good for economies because home owners feel richer, and they tend to spend more. However, too much of a good thing could turn into an unsustainable boom that could eventually create significant problems.

The progress on recovery and associated reflating of economies means that central bankers face the difficult task in policy normalization in the second half of the year. While in the first half, central bank mandates were relatively clear (maintain easy monetary policy), the economic reopening means central bankers globally need to consider unwinding both asset purchases and near-zero rates. More than that, they need to carefully navigate between growth and inflation. This is a complicated and uncertain process, as the usual indicators and benchmarks that central bankers rely on are not as helpful as they normally might be following a conventional recession.

In the US, the risk is for the Federal Reserve to misjudge the navigation between high inflation and a tight labour market on one hand, and fundamental slack in the economy on the other. The labour market appears to be extremely tight, with far fewer people re-entering the labour force than expected. This has driven wage pressure up as other prices (such as used cars and building materials) have risen. The Fed will need to weigh the need to reduce inflationary pressures with its own assessment of labour market slack.

For China, a key risk is of policy misstep, with Beijing pushing an aggressive program against big tech, the education sector, and various other enterprises that it deems have become too independent and “profit-focused”. Part of this “de-risking program” is to encourage more corporate defaults in a bid to introduce more market discipline as well as maintain central government influence. However if they are too aggressive, Beijing risks triggering a credit crunch or disorderly contagion in the domestic financial markets. We expect that slower growth momentum in the second half of 2021 amid a credit slowdown suggests some stabilization in global commodity prices ahead.

In Europe, the European Central Bank (ECB) will err on the side of caution and tolerate a period of above target inflation as the economy rebounds from the pandemic shock. A key unknown for the ECB at this point is the amount of slack or permanent damage that the economy will be operating with once government support programs are withdrawn. A similar uncertainty faces the Bank of England (BoE). While both the ECB and BoE are forecasting that inflation will return to their policy targets in 2022-23, the risk is that inflationary forces may prove more enduring than currently assumed, triggering a faster and sooner-than-expected tightening of policy.

Although Europe is expected to continue reopening in the second half of the year and is likely to experience a boom in consumer spending as households wind down some of their enforced higher savings levels, government stimulus has been more restrained than that seen in the US or Australia and European economies are, in general, operating with more slack than is evident elsewhere.

Inflation remains a global topic of concern, and is expected to rise above target levels in 2021. The pace of inflation has been rising due to strong demand, higher commodity prices, base effects (due to abnormally low inflation in 2020) and stressed supply chains. These factors are expected to be largely transient, and resolve over the next 12 months without leading to further rising levels of inflation.

In summary, we note the following:

- In most developed markets, today’s cash rates and projected cash rates are below the actual and likely inflation rate. Thus these rates represent negative real yields, which are highly stimulatory for those economies;
- The projected rise in yields by either the bank bill futures market (or the RBA) will probably not affect risk markets. In Australia, equity market yields and property yields are around 3% higher than the projected cash rates of 2 years hence;
- Equities and property assets are growth assets whose cash generation is supported by economic growth and inflation. To an extent, they are a hedge against inflation; and
- Sustained negative real yields, mild inflation, and predictable economic growth (as borders open in 2022/2023) suggest equities and property markets will continue to perform relatively well whilst bonds will not.

As investors look for opportunities, the divergent performance of various parts of the global economy means that some sectors, such as international travel, education, and hospitality, will remain weak. Other sectors, such as technology services, housing, and construction, have been buoyed by both government support and household demand. And yet other sectors, such as resource exports, have been sustained by extraordinary demand emanating from China, Japan, and other Asian countries.

There remain reasons to be optimistic about the potential for high quality listed companies to grow values in line with the economic recovery. In our view, the current trajectory of bond markets, equity markets and property assets will probably continue along their current paths, despite some angst about the risks of further pandemic pain, inflation, QE tapering, tax increases, and other perils. Therefore we remain constructive regarding growth-oriented investment markets.

Portfolio Commentary

While the S&P/ASX200 Accumulation Index delivered a solid return of +1.1% for the month, the ASX still lagged the 2.4% rise of the S&P 500. China’s stock market corrected by nearly 14% in July due largely to the regulatory crackdown, and was a drag on Emerging Markets (-6%) and other Asian markets (Korea -3.6%, Japan -2.4%).

Domestically, Materials (+7.1%) and Industrials (+4.2%) led the way, while Technology (-6.9%) and Energy (-2.5%) underperformed.

Key contributors and detractors to the portfolio return for the month were:

- **Large Cap Australian Equities:** Key contributors; MIN (+17.3%), SVW (+14.3%), BHP (+10.1%), no significant detractors.
- **Small Cap Australian Equities:** No significant contributors, no significant detractors.
- **Income & Other Securities:** AB Global Equity Fund (+3.3%), no significant detractors.

BHP Group (BHP) returned +10.1% as the market continued to upgrade earnings expectations in the context of very high iron ore and copper prices. This is translating to exceptionally high cash flows and expected dividends. The iron ore price in fact fell by 11.4% in the month, partially offset by 2.1% strengthening of the USD against the AUD. This is a result of curbs on steel production in China to reduce pollution, with the aim of holding production at the 2020 level this calendar year. In the first half of the year, Chinese steel production gained 12% while iron ore supply was below expectations.

Mineral Resources (MIN) gained +17.3%, benefiting from the same iron ore tailwinds as BHP as well as strength in the lithium price. Lithium pricing has increased by almost 100% this calendar year in the context of accelerating demand for electric vehicles.

Seven Group (SVW) returned +14.3% as they secured 70% ownership in Boral and given a robust earnings outlook for the existing business, which is leveraged to infrastructure, resources, and broader construction. SVW has now attained effective control of Boral without paying a takeover premium. Management is confident of their ability to turn around an historically underperforming Boral business, while the planned divestment of US assets will free up significant capital.

Westpac (WBC) returned -5.0% as lockdowns around Australia are likely to have an impact on bad debts. Last year, the sector took significant provisions for expected defaults, which they were able to substantially reverse following a rapid economic recovery.

Following a solid start to the new financial year, we now enter reporting season with relatively high expectations. Consensus estimates currently reflect expectations for earnings growth of about 25% for FY2021, slowing to 10% growth in FY2022. Given the raft of lockdowns currently impacting the domestic economy, and despite the solid health of corporate Australia, we expect outlook statements to remain circumspect.

Sterling Clime Conservative Portfolio (SR0010)

Portfolio Snapshot

| Inception Date | SMA Model Code | Portfolio Objective | Benchmark |
|-------------------|----------------|--|---|
| 20th October 2017 | SR0010 | Deliver strong risk-adjusted total returns | Blended Conservative Index ¹ |

Top 5 Holdings

| Security | Weight (%) |
|--|------------|
| Realm High Income Fund | 15.1 |
| Charter Hall Maxim Property Securities | 8.7 |
| CBA Capital Notes 2021 (CBAPJ) | 3.7 |
| CBA Capital Notes 2018 (CBAPI) | 3.7 |
| ANZ Capital Notes 2016 (ANZPG) | 3.7 |

¹Sterling Clime Blended Conservative Index is comprised of a 20% weighting to S&P/ASX 200 Accumulation Index, 5% to S&P/ASX 200 A-REIT Accumulation Index, 5% weighting to MSCI World ex Australia Index (AUD), 60% weighting to the Bloomberg AusBond Composite Index and 10% weighting to the RBA Cash Rate.

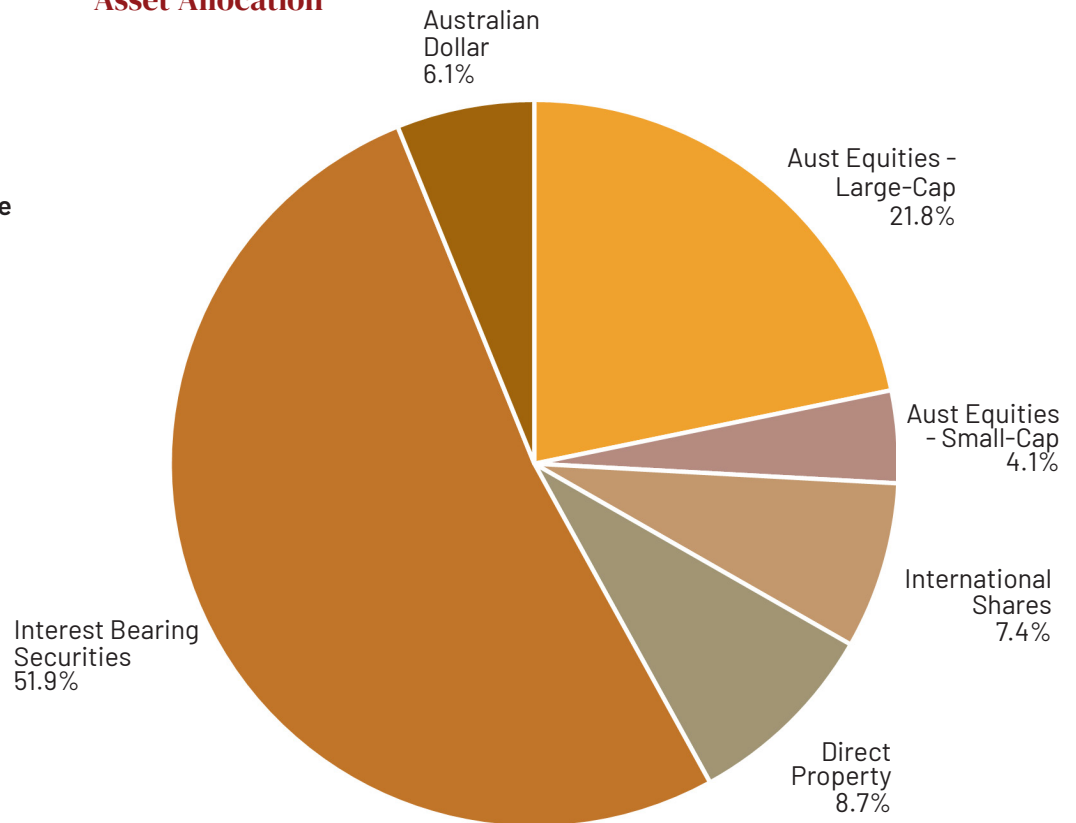
Sterling Clime Conservative Portfolio (SR0010)

About the Model Manager

Clime applies a consistent approach to identify the most attractive investment opportunities within the universe of stocks.

Clime invests with a focus on quality and a strong valuation discipline. Our investment solutions are centred on helping clients grow their wealth.

Asset Allocation



Portfolio Performance (31/07/2021)

| | 1 m | 3 m | 6 m | 1 y p.a | 3 y p.a | Inception p.a |
|------------------------------------|-------|------|------|---------|---------|---------------|
| Portfolio Return | 1.2% | 3.7% | 7.8% | 14.4% | 6.1% | 6.3% |
| Capital Return | 1.2% | 2.7% | 6.0% | 11.3% | 2.8% | 2.9% |
| Income Return | 0.0% | 1.0% | 1.8% | 3.1% | 3.3% | 3.4% |
| Sterling Conservative Index | 1.4% | 3.4% | 4.5% | 8.9% | 6.4% | 6.4% |
| Difference | -0.2% | 0.3% | 3.3% | 5.5% | -0.3% | -0.1% |

Number of Individual Holdings (excluding cash): 35