Fidelity INTERNATIONAL

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Recession-proofing the portfolio

The August reporting season saw some strong results. Sales were solid, higher input costs were passed on by most companies, balance sheets were in good health and shareholders were rewarded with some large dividends. With unemployment low, the consumer was still spending, and we saw positive results across the retail sector. However, like all reporting seasons, results were backward looking and this one seemed to represent a turning point. Going forward, the market will be more focused on interest rates, the prospect of an economic slowdown and maybe even a recession in 2023.

The Reserve Bank of Australia (RBA) has recently taken official interest rates from zero to 2.35%. The US Fed has been more aggressive, with official interest rates now sitting between 3 and 3.25%. These initial interest rate moves have not had any significant impacts for either economy with low unemployment and consumer confidence still riding high. However, the Fed in particular, seems determined not to repeat the policy mistakes of the 1970s and 1980s when they were criticised for being slow to act in the belief inflation was transitory. They now seem to be erring on the side of over-action.

With interest rates expected to keep rising, the likelihood that the US and Europe will enter a recession in early 2023 is increasing, but it's less certain if Australia will follow suit. High energy costs coupled with better conditions for commodities will help cushion the blow to the Australian economy, but future rate rises could do some damage. An official interest rate of 4% has the potential to push mortgage rates to the 6% range, putting considerable pressure on a highly leveraged Australian consumer.

Implications for the portfolio

So with higher interest rates, a weak consumer and a potential recession in 2023, how have we positioned the portfolio? Stocks in the Fidelity Australia Equities Fund basically fall within three buckets: (1) Essentials, (2) Cheap sectors, and (3) Self-help.

History demonstrates that businesses that provide essential goods and services perform well through inflationary periods and recessions. By their nature, they are 'essential' and people continue to buy and consume these products and services regardless of market conditions. In addition, these types of businesses are in a much better position to pass on higher input costs, once again because they are essential. Inflation actually helps them grow. Examples of essential businesses include supermarkets, consumer staples, healthcare, telecommunications, and utilities. The Fund has over-weight positions in Coles, Ramsay Healthcare and Telstra that fall into this category.

By far the cheapest sectors in the market now are energy, materials, and insurance. The commodity sectors have very strong balance sheets and cash flows. And although they are negatively impacted by recessions, they have the prospect of an improving China. The Chinese economy has been negatively impacted by their zero-Covid government policy. However, unlike most of the rest of the world, China is easing monetary policy and the worse the fallout from Covid policy, the higher the likelihood of fiscal stimulus.

Better prospects from China combined with cheap valuations starts to move the odds in favour of the commodity sectors. In addition, we believe the process of decarbonisation is at an extremely metal-intensive phase of development and companies with exposure to transition metals and energy sources like nickel, natural gas, copper, and lithium will be best positioned within the commodity sectors.

The insurance sector is similarly extremely cheap and with premiums on the rise, we believe the general insurance sector is well positioned for growth. The Fund has significant over-weight positions in IGO, Santos and Suncorp. Suncorp is also a good example of a stock that falls within the self-help bucket. Suncorp has been simplifying its business and, with the sale of the bank, will become a very focused general insurance business. This

greater business focus should bring considerably improved valuation metrics.

The banking sector should also benefit in the shorter term from higher interest rates and a steepening yield curve; however, this is only up to a point. Higher interest rates will likely bring higher loan loss provisions and a decrease in borrowing. While we are under-weight banks, we have a significant over-weight position in Commonwealth Bank (CBA) due to its strong balance sheet and superior technology platform. CBA also benefits the most from rising interest rates, steepening yield curve and improved net interest margins given its very significant deposit base.

By structuring the portfolio into these three buckets – (1) Essentials, (2) Cheap sectors and (3) Self-help – I believe we've positioned the Fidelity Australian Equities Fund not only to weather but to thrive throughout any potential economic slowdown or recession. More importantly, I believe, when we talk five years from now, we'll look back at this period of volatility and recognise it as a very attractive time to have invested in markets for the long term.

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