fatPROPHETS™

2021 Review

December 22, 2021 FAT-AUS-1050

A Year of Recovery

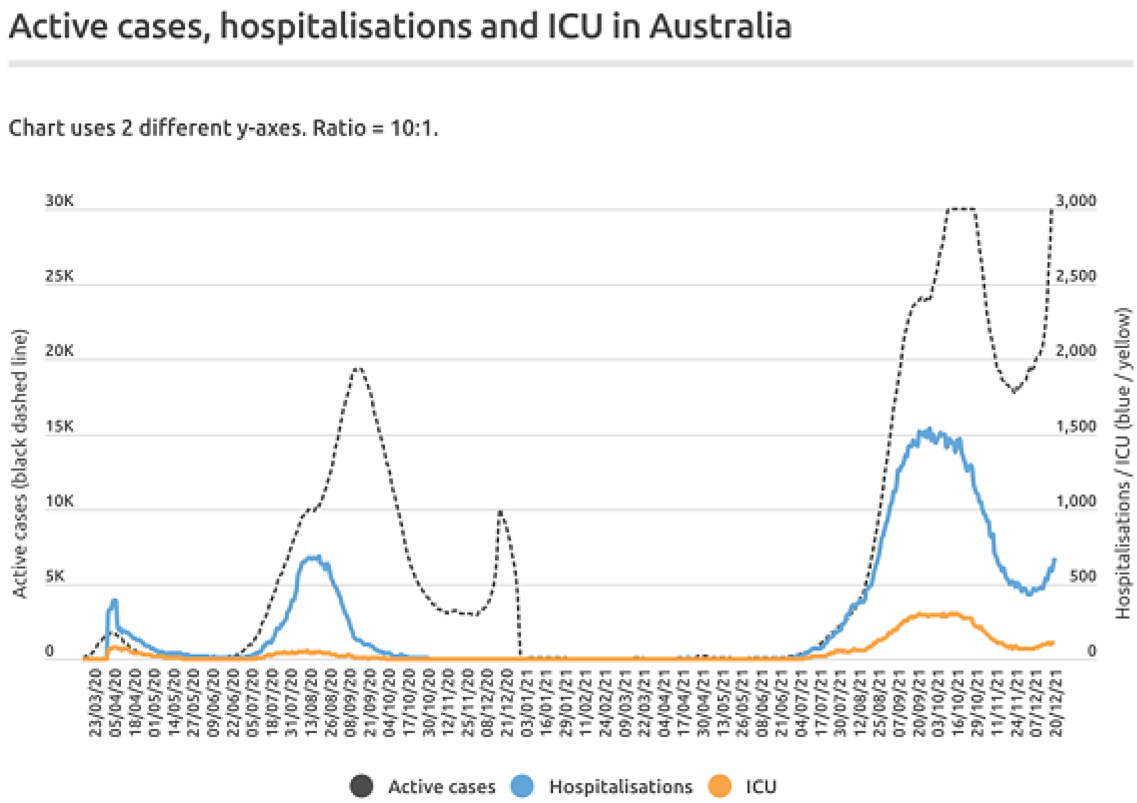
With 2021 about to enter the history books in less than two weeks we look back at the year that was and although we didn't see the same levels of volatility as in 2020 – a year that saw the word 'unprecedented' very much in vogue – **we have certainly seen our shares of ups and downs in relation to the progress of the pandemic (which unfortunately isn't over yet) and this continued to impact financial markets in 2021.**

Populaces entered the year full of optimism, with vaccines that had been developed in a rapid fashion and were much more effective than most would have expected. Early in 2021, the global economy was largely reopening and in Australia, where health and economic outcomes had overall been much better than most expected, life was pretty good relative to most other parts of the world. **The emergence of the Delta variant saw new cases pick up globally and posed Australia's sternest test until that time**, with it spreading rapidly after the initial cases were imported, leading to NSW, Victoria and ACT (including the economic engine of Sydney) largely being in lockdown over the July – September period.

This encouraged a rapid take-up of vaccinations and after a slow start, Australia has quickly hit high vaccination levels, paving the way for more freedoms and reopening over the past couple of months. Australia is now largely in full reopening mode, with long shut borders reopened. The Omicron variant first identified in South Africa in November has been yet another unpleasant surprise, as its mutations give it the ability to evade current vaccines. **Booster shots, particularly of the mRNA (Pfizer and Moderna) type vaccines, are now being pushed to bolster protection against infection of the new variant and most importantly to protect against severe illness.**

Data is still emerging on the Omicron variant, but the hopes are it is somewhat less pathogenic than the Delta strain, although it is much more transmissible. The problem is that even a small percentage of severely ill of a large number of cases could pressure healthcare systems. **Pressure on the UK government for example to impose further restrictions is growing due to a 'tidal wave' of new infections.** In the Netherlands, which has fewer ICU beds than in most other countries of its level of wealth, a new lockdown has been imposed and Denmark has closed bars and schools early. Denmark is widely followed, given it tests more per capita than other countries and sequences cases at a high level. **In other countries, various other actions are being mulled ranging from mask mandates to more restrictive measures.**

New daily cases in Australia are surging again but authorities have largely shown little sign or appetite for tightening restrictions again, instead, relying on high levels of vaccinations and encouraging booster uptake as the defence. **The focus, rightly so in our view, has shifted to living with Covid-19. Hospitalisations and strain on the healthcare system are now the more important metrics rather than simply case numbers.**



Source:covid19data.com.au/hospitalisations-icu

Whether tighter restrictions will again be reimposed is a question mark and the Omicron variant, along with the spectre of inflation and likelihood of central bank resetting in 2022 has generated some recent volatility and is heightening financial markets uncertainty heading into 2022. **In the first weeks of January, we will publish our Baker's Dozen of predictions for 2022. Today though, our focus is on the year that just was.**

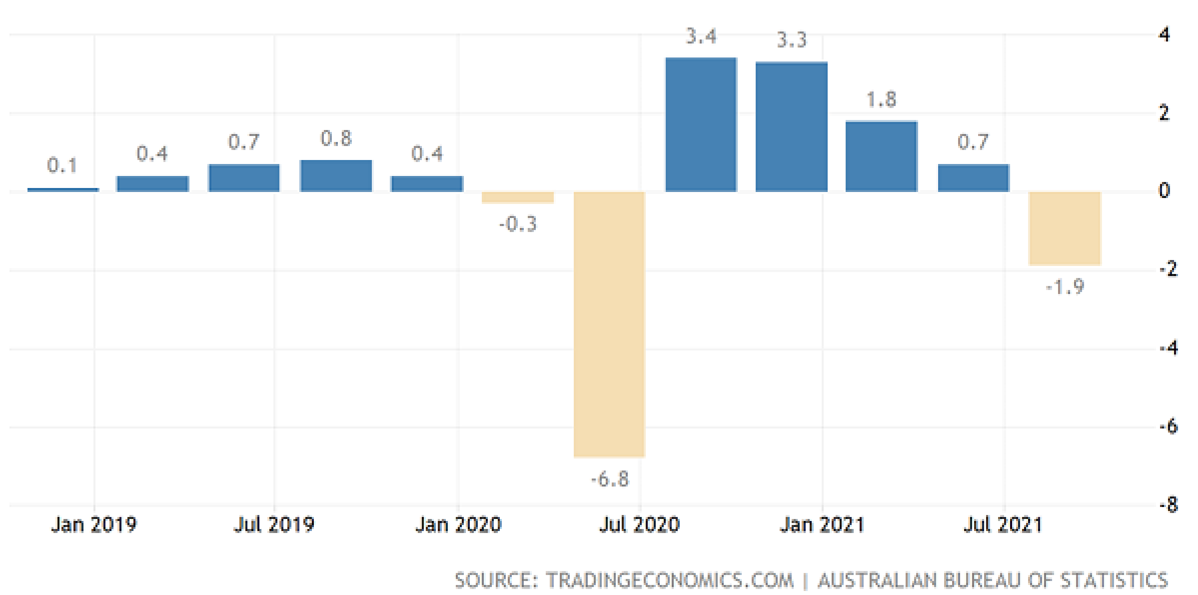
In Australia and most developed countries, the shift towards remote working in 2020 was a grand experiment that was more successful than many would have dreamed. Especially in 2021 with large numbers still working from home. Indeed, it has shifted the landscape and a hybrid work environment seems the likely status quo on the other side of the pandemic. **The success of remote working, along with all the lessons we have learned, the vaccines and new treatments on**

the way, such as the oral antiviral pills, helps bolster our confidence that Omicron's impact on economies will be lesser relative to the other, earlier waves we have seen since the pandemic began.

Despite the 1.9% shrinkage in the third quarter GDP due to lockdowns across NSW, Victoria and ACT, the Australian economy has been robust through 2021. The 1.9% contraction was much less than the consensus estimate for a 2.7% decline. The less than feared contraction was the first since June quarter 2020, and as household consumption fell 4.8% for the first time in five quarters dragged down by spending on services, while private investment rose 0.8%, the least in a year, due to a sharp slowdown in dwellings investment and a fall in machinery and equipment investment.

Meantime, government spending expanded much faster rising 3.6%, led by health-related expenditure. Net external demand contributed positively, as exports of goods and services rose 1.2%, supported by mining and rural commodities, while imports dropped 4.0% due to persistent global supply constraints and a fall in domestic demand.

Australia GDP (QoQ)



At an annual rate, GDP expanded 3.9% and the signs are there for a rebound again in 4Q21, when the figures are released, similar to the experience after 2Q20, with the Australian economy benefitting from strong pent-up demand and savings accumulated through the pandemic. Rising house values have supported consumer sentiment. Indeed, **the ABS said in December that total household wealth increased 4.4%, or by $590 billion in the September quarter to a record $13.9 trillion.**

Australia's unemployment rate improved 0.6 percentage points to 4.6% in November, as 366,100 jobs were added to the economy – a record number – as states reopened. That was well above the 200,000 new jobs economists were forecasting and better than the 5% estimated jobless rate.

At the December meeting, the Reserve Bank of Australia (RBA), **as expected, stayed pat on the cash rate but announced a tapering of the bond-buying program that will get underway in February and reduce quickly over several**

months. The RBA remains non-committal over just when rates will be hiked in 2022.

The RBA held the cash rate at a record low rate of 0.1% at its Board meeting on the first Tuesday in December. In a statement, **Governor Lowe said the cash rate would remain unchanged until actual inflation is sustainably within the 2% to 3% target range.** This requires the labour market to be tight enough to generate wages growth that is materially higher than it is currently. The RBA will continue to purchase government securities at a rate of $4 billion per week until at least mid-February 2022, but this falls away sharply from that point on.

In its December statement, the RBA remained noncommittal over hiking rates and removed any reference to a date in which it expects macroeconomic conditions and sustainable inflation to allow for a cash rate change. The RBA stuck to its line that "it didn't expect these conditions to be met until the end of 2023. **While the RBA is paving the way for the first upward move in cash rates in a decade, these are cautious baby steps and like the Fed, Australia risks falling behind the curve on the inflation front.**

Bad debts in the developed economies, including the US and Australia, have been a shadow of levels feared in the early stages of the pandemic back in 2020. **Pent-up savings and strong demand led to strong rebounds in economic activity in the US, Europe and Australia among other countries in 2021.**

Inflation began to emerge in 2021, as a serious potential problem in the US and Europe, but to a much lesser extent in Australia – although we are less sanguine than the Reserve Bank of Australia on the threat it poses domestically without action. The narrative in the first half of 2021 see-sawed between whether inflation would be transitory or structural, with the world's most influential central bank – **The Federal Reserve – singing the tune for much of 2021 that it would be transitory.** A view that Jerome Powell & Co have only recently reversed their position on.

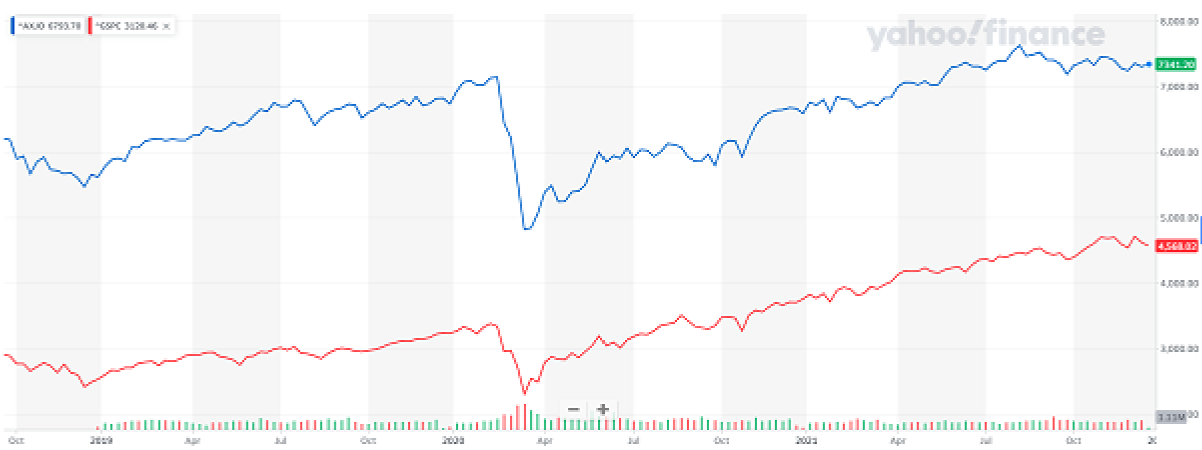
Australia Annual Inflation Rate (QoQ)

Supply chain disruptions have no doubt played a major role and are still a problem. China's zero-Covid strategy has added to these woes with sporadic disruption at major manufacturing centres and ports in China having knock-on effects. **We do see this risk to supply chains continuing for some time and this will likely continue to place upward pressure on inflation.**

Equities markets were generally strong in 2021, with the US leading the way. In Australia, the market did quite well while lagging the S&P500 benchmark and of course residential real estate soared in value. In a December update, CoreLogic noted that the estimated value of Australia's residential real estate had increased from $7.2 trillion at the end of November 2020, to hit a record high of $9.4 trillion a year later, as dwelling values nationally increased 22.2%, the highest increase since 1989.

"Strong housing market performance over the year was driven by multiple factors, including low interest rates, fiscal and institutional support for households, high household savings and relatively low levels of advertised stock," said CoreLogic Head of Research Eliza Owen.

At the time of writing the S&P/ASX200 benchmark was up about 10.13% year-to-date, lagging the 25.63% upward charge for the S&P500. A strong rebound in corporate earnings, low interest rates available for cash and little appeal in holding bonds helped support stocks, even as some sectors and particular stocks hit lofty levels, influencing other indexes. **This is a decent performance from the ASX200 following on from a flattish 2020 (which staged a strong rebound after the crash in March 2020) and a strong 2019.**

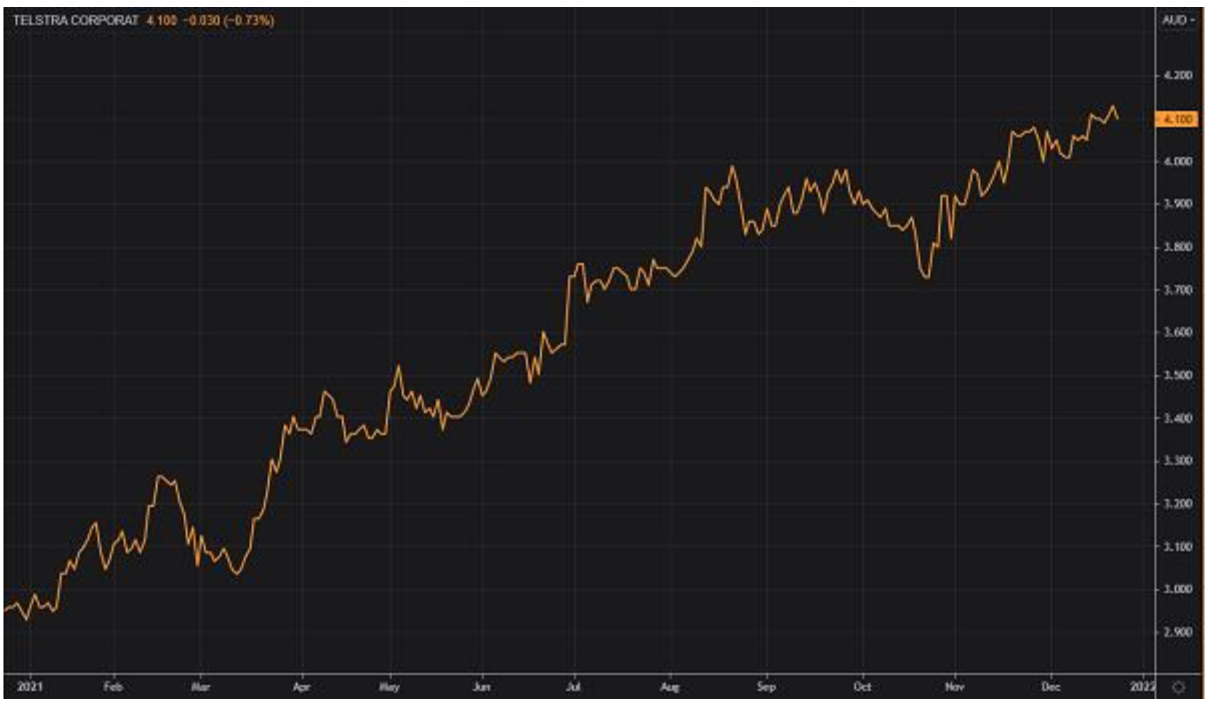


Source: Yahoo Finance

The performance in Australian equities has been supported by generally better than expected earnings, albeit with unevenness across sectors due to the pandemic.

The **telecommunication sector** was a strong performer, driven by a solid ascent (approaching 40%) of the sector gorilla **Telstra**. Telstra was one of our favoured recommendations and the stock rose as the market became more comfortable with the execution of its strategic transformation, with Telstra hitting many of its goals for T22 and unveiling the next stage T25 strategy. Investors have also been pleased with the monetisation initiatives underway such as infrastructure and its leadership in 5G, with new monetisation possibilities and expectations of improved price rationality in the key mobile space.

Telstra



The **financial sector** has been a solid performer, driven by the heavyweight banks. We have continued to be positive on the banks (recommending **NAB, ANZ, WBC** and smaller bank **BOQ**) since the sell-off in 2020, citing a much mellower than expected bad debts backdrop and the scope for provisions charges to be reversed along with the return of higher dividends and share buybacks. The recovery that got underway in 2020 following the crash in March for the sector continued in 2021, with investors attracted to their leverage to the strong economic recovery underway, the return of higher dividends and share buybacks as provisions provided for in 2020 proved excessive, and the prospects of higher interest rates on the horizon – good for the core banking businesses. Overall, we have been content with how this has played out over 2021, even with a recent pullback from 52-week highs, on intense mortgage competition.

Insurers are set to benefit from higher interest rates and bond yields on the horizon and **QBE**, which we continue to recommend as a buy, has been a solid performer in 2021. The continued high relative level of catastrophes continues to be a headwind for the industry but the powerful macro drivers of higher bond yields on the horizon and firming premiums, along with some positive company-specific developments are supportive. The underlying QBE business has improved in quality in recent years in our view even as headline numbers sometimes obscured progress and there were tough blows from Covid-19, investment losses and elevated catastrophe levels on different occasions.

Management moved to simplify the business, sell non-core or underperforming portfolios. Underlying operational efficiency has been improving and the 1H21 results swung back firmly into profit territory. Premiums have firmed over the past few years across most regions due to several reasons and we expect to see this continue for some time on a more rational pricing environment for the industry, due to the reduced capacity in the market and the need to recover losses from elevated catastrophe activity. Although there have been some signs of moderation, QBE has reported strong premium rises over the past couple of years.

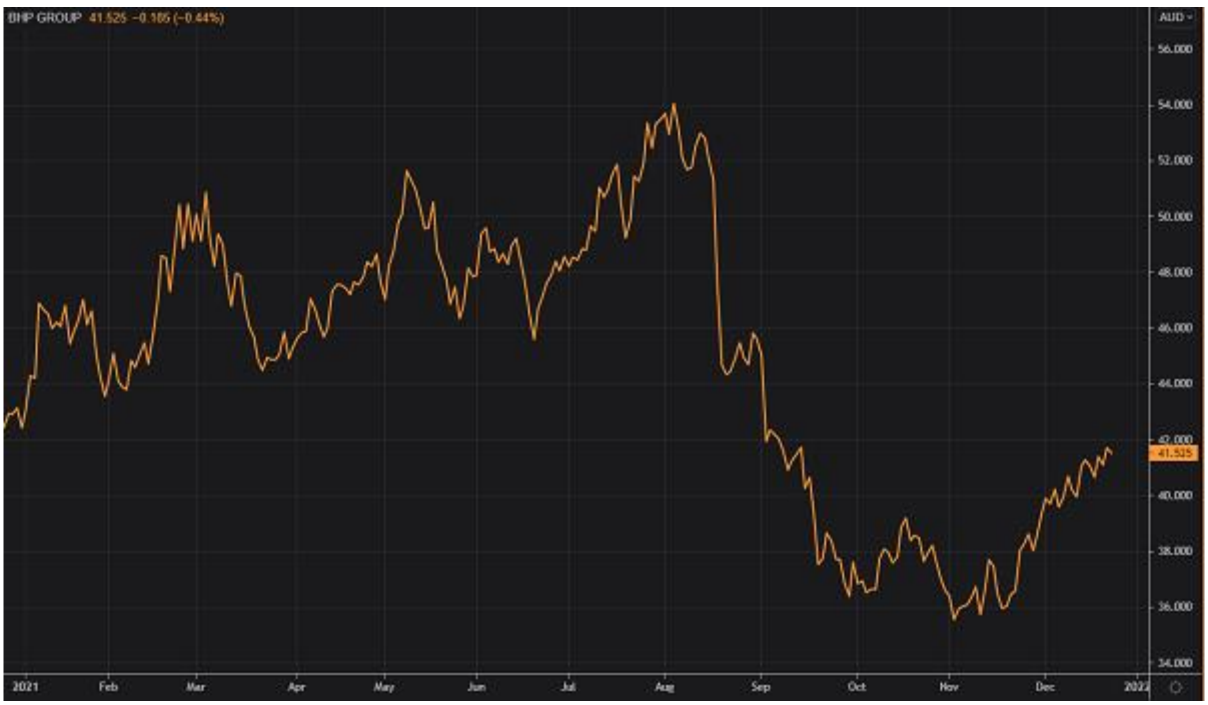
QBE

Materials/Resources are a major component of the Australian stock market, with the second-largest weighting in the ASX200 after Financials. The sector marched firmly higher over the first two-thirds of the year, before enduring a correction in August and September, before seeming to find a base and begin recovering again from November.

Source: Trading Economics

Iron ore prices surged from mid-2020 through to mid-2021 (it hit an all-time high of roughly $230 per tonne in May 2021) before facing a sharp pullback on Chinese woes. Beijing has cracked down on several industries, denting growth prospects for the broader economy. Importantly, Beijing is curbing speculation in the property sector, a large consumer of steel (and iron ore as the feeder), with worries about a looming collapse of Evergrande (and the possibility of contagion for the broader sector) a significant factor. Iron ore imports by China have remained high though, hitting a 16-month high in November, and industrial production there remains robust, underpinning demand for **BHP** and **Rio Tinto**'s iron ore. We recommended BHP and Rio Tinto as buys in September, following hold recommendations initiated in December 2020 for BHP and January 2021 for Rio Tinto. The share prices for both proceeded to record highs in early July. On the reasons given above, both shares corrected sharply from their record highs to their recent lows by November. We viewed the price weakness as an opportune time to reentry both, given our positive longer term view of the Chinese steel industry. Ongoing infrastructure spending by many governments in 2022 and beyond, including China and the US, will continue to support a strong Chinese steel industry and hence iron ore prices. Additional tailwinds from a weaker US dollar and rising inflation will also provide a boost for the iron ore price in 2022.

BHP



We continue to have a favourable view on the broader commodities complex in an inflationary environment, with headline consumer inflation hitting 6.8% in November for the US – the highest level since June 1982. Factory-gate inflation is running even hotter, hitting a whopping 9.6% in November.

Producer prices change (factory-gate inflation) in the US

We see inflation continuing to be elevated heading into 2022. The US M2 (a money supply measure) remains at elevated levels, as US spending programmes and the economic recovery sustain the velocity of dollars circulating in the economy. M2 is growing at a velocity not seen since the early 1940s. The Fed has recently changed its stance from dovish to hawkish in acknowledgement that it cannot let inflation run unchecked, but the process to turn back the clock on inflation is not easy and/or quick. At the moment, all the Fed has done is accelerate its taper for asset purchases, with interest rate hikes yet to come. Given blowout spending and deficits in the US, with a debt-to-GDP ratio that has soared, **we expect looming weakness for the greenback, which is generally positive for commodities demand.**

Back to China and recently, China's Central Economic Work Conference, emphasized "stability," which means **various policy measures will be taken to boost demand, support market entities and ensure stable growth in 2022.**

"The huge potential of China's development lies in the vast rural areas and the central and western regions. We should tap into this potential and transform the potential into effective demand," said deputy head of the National Development and Reform Commission.

We see this as reminiscent of the migration from rural China to the cities that drove immense growth over the first decade of the 21st century. Commodities entered a real supercycle, and we could already be in another such cycle. **Lithium, cobalt and nickel are set to enjoy a secular increase in demand from the rise in electric vehicles, which we have written about often in our research this year (and previously).** We continue to maintain a buy recommendation on **Allkem (nee Orocobre)**, especially following its successful acquisition of Galaxy Resources, which significantly lifts its lithium production profile to upward of 210,000 tonnes in 2022. **IGO Group** also made an acquisition in the lithium space in acquiring Tianqi Lithium that holds a 51% interest in the Greenbushes lithium mine, that see it become a major producer in the vicinity of 1.95 million tonnes of lithium spodumene annually. We have a buy recommendation on IGO Group.

CRB Commodities Index

Source: Trading Economics

It isn't just so-called 'hard' commodities that we were favourable on, but also 'soft' agricultural commodities, with the drought eased and better conditions locally, along with strong demand lifting soft-commodity prices. **Elders and Nufarm** have advanced year-to-date, and we **see favourable tailwinds persisting in 2022.**

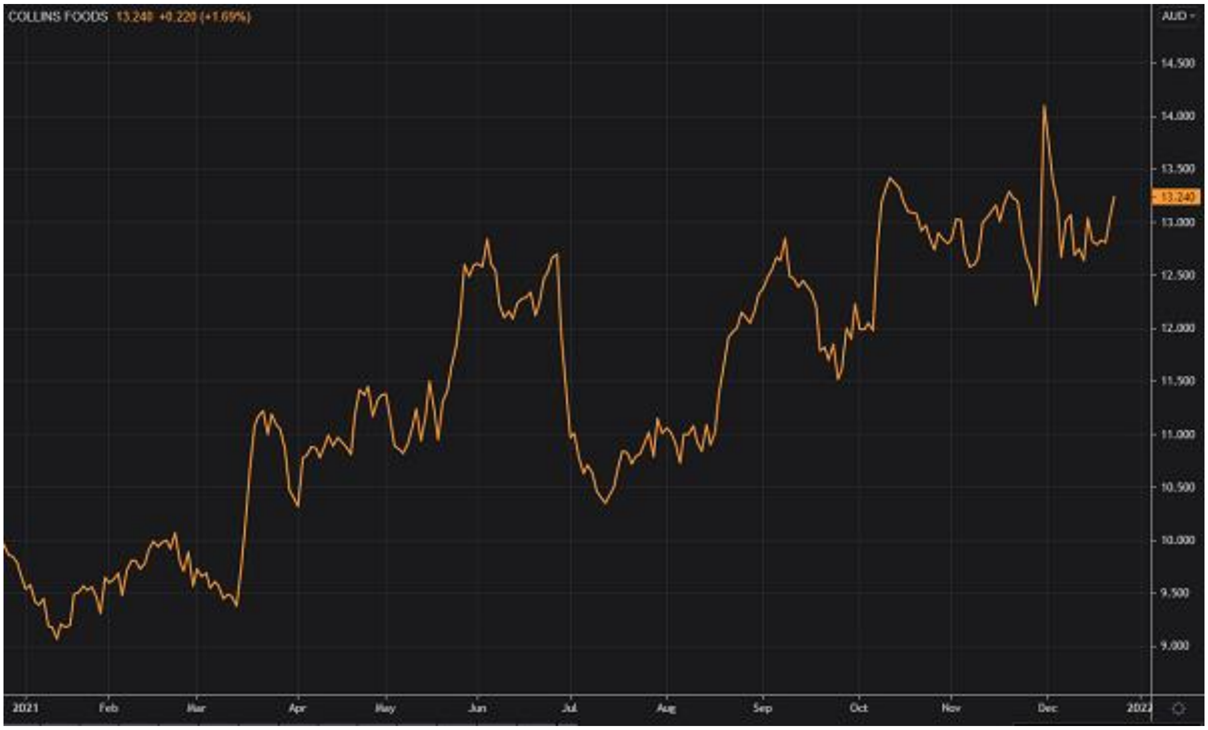
Mergers and acquisition (M&A) activity hit record highs globally this year, soaring 63% to $5.6 trillion with broad-based gains by region. Deal making in the US nearly doubled, increased by nearly a half in Europe and is up nearly 40% in Asia Pacific, with cheap financing, abundant capital, strong balance sheets and high stock valuations were (useful for scrip-based deals) significant contributing factors.

Australia certainly participated in the party, with deals involving Australian companies exceeding $390 billion in the first nine months of the year alone, surpassing the comparable period amount of the three previous years combined according to Reuters reporting based on Refinitiv data. Infrastructure and resources were busy areas, but activity was broad-based, with US-based payments firm Square (now called Block) making a A$39 billion play for homegrown fintech giant Afterpay. Coca-Cola European Partners acquired Coca-Cola Amatil for A$9.9b, and the A$23.6 billion proposed takeover of **Sydney Airport** by a consortium of investors was announced early in the year.

Santos and **Oil Search** merged in another mega-deal and **Woodside** combined with **BHP**'s petroleum business. There was plenty of activity at the smaller end of town as well, with our financial service platform recommendations featuring here. **HUB24** has made a play for Class Ltd and recently **Praemium** has snubbed a $795 million merger offer from Netwealth, believing it undervalues this business – we concur.

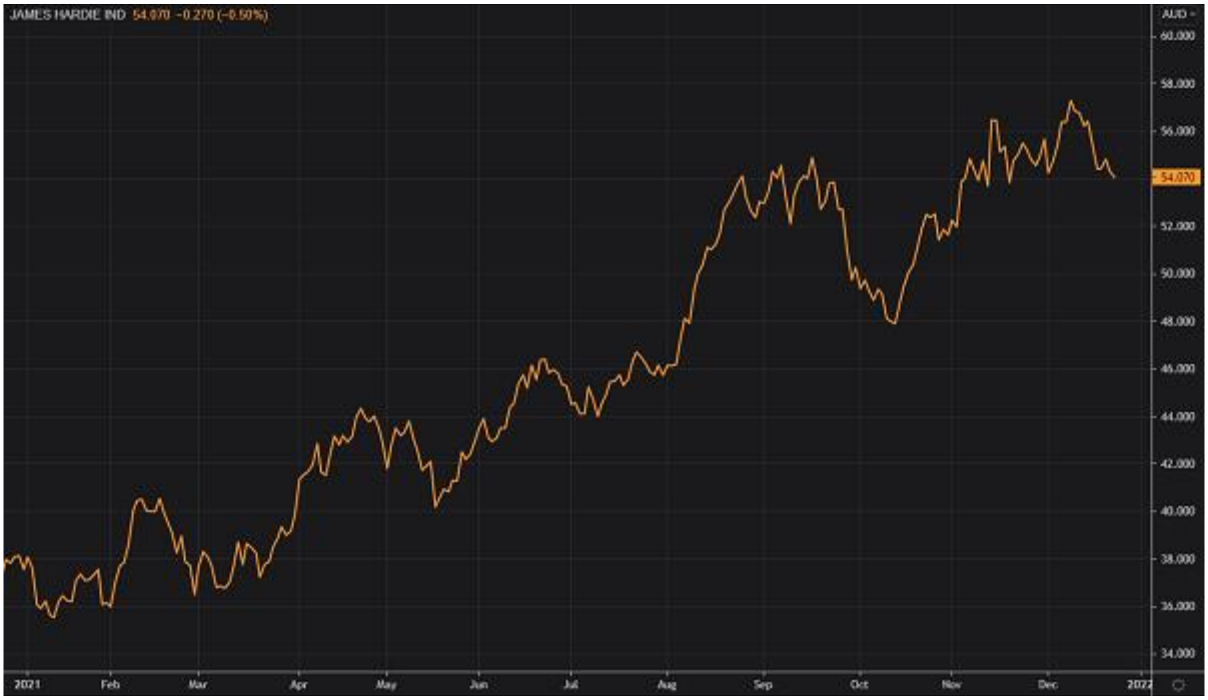
In other areas, we continued to back QSR operator **Collins Foods** and recently shifted our rating on **Domino's** back to a buy after a correction. Both are well run businesses with strong growth runways on overseas expansion and impressive digital capabilities. Collins Foods has run strongly, while after shifting our rating back to a buy on Domino's the stock is yet to do much.

Collins Foods



Our call for a strong economic recovery in 2021 saw us backing the likes of James Hardie and Domain, which have both been strong performers. We recently recommended Members take some profits off the table on Domain, as the real estate market has been red-hot. **See our separate report for where we took profits and losses on our sell/sell-half recommendations in 2021.**

James Hardie



New Recommendations

We made six new stock introductions to the research portfolio this year, a smaller number than last year but consistent with the value we saw in the broader market. **The recovery moved quickly in the latter part of 2020 and by 2021 there were pockets of excess valuations in our view, requiring a targeted approach.**

The first stock we introduced to the research portfolio was **Treasury Wine Estates** back in March after first having flagged it with traffic light coverage a month or so before. The company had faced a major setback due to the punitive tariffs China had imposed on Australian wines, as the relationship between China and Australia became very chilly. After reviewing the interim results, commentary from management and an improvement in the technical picture, by March we felt the risk-to-reward proposition for Treasury Wine Estates was to our taste.

The company is gaining traction in redirecting its wine sales outside of China and over time this adds to the appeal by diversifying the sales base and reducing the reliance on the often-fractious relationship with China. The company has ample liquidity and is leveraged to the ‘premiumisation’ of the global wine market. We also see there being scope for the company to lift margins towards the 25% mark over time, with its Penfolds range being a true vintage. While not part our core investment thesis, takeover potential is a wild card. The stock has advanced modestly since joining the research portfolio.

In April, we added small-cap insurer **Tower New Zealand** (it trades on both the Australian and New Zealand stock exchanges under TWR), as we see it being a beneficiary of firming premiums, the prospects of a returning dividend and the digitisation of its business – the benefits being reduced costs, improved efficiencies and enhancing the company experience. A line had recently been drawn under claims relating to the 2010/11 Christchurch earthquakes and targeted acquisitions had bolstered the book. We have a positive view on management and saw scope for increasing broker coverage going forward. Our timing has proved a bit off, leading to a soft start for the recommendation but it is early days yet.

In July we added two new stocks, being **Whitehaven Coal** and **APA Group**. After a tough 2020, we saw Whitehaven Coal, as a recovery play with its financials set to rebound strongly on a rally in thermal coal prices. This has largely played out, with the shares rallying through to September. Even after the pullback recently, the shares have made solid gains since being introduced to the portfolio.

The other stock introduced in July was APA Group, which we see leveraged to the reflation trade. The utility is the country’s biggest provider of energy infrastructure. The company has a good dividend, should be resilient during periods of volatility and we believe has a decent growth angle, with a track record of acquisitions. We felt this would more than compensate for bond yields inflecting higher, which we expected to be the case over the medium-term. The majority of revenue is set to benefit from 'inflation linked escalation and APA has hedged its own interest rate exposure on the balance sheet. The shares have ticked up since our initial recommendation and the company lobbed a near $10 billion bid for AusNet in September in a tussle with Canada's Brookfield.

In August we introduced iron ore titan **Fortescue** as a buy to Members after the iron ore price had faced a steep correction, taking Fortescue along with it. We saw this as an opportunity to buy a quality company at a decent price, setting up well for the medium-term. After heading lower for a short time after the initial recommendation, the shares have recovered to around our initial recommendation price. We are content that our entry point is a decent one, with the company set to benefit from higher iron ore prices in coming years, with a potential blue sky from investments in renewables such as hydrogen. Founder Andrew "Twiggy" Forest has grown shareholder value (and his own wealth) by huge amounts and is a very savvy businessman.

Finally, the most recent stock introduced to the research portfolio was **Adore Beauty** in early December. After a high-profile IPO in October 2020, at a somewhat lofty valuation (typical for private equity shareholders seeking an exit), the shares endured a sharp correction in the first half of 2021 before a modest recovery. After some additional weakness in November, we viewed the valuation as offering an appealing risk-to-reward proposition for the online beauty store.

The company remains well-positioned to benefit from the structural shift to online and continues to deliver solid growth, while having a strong balance sheet. Brand awareness continues to grow, along with the active customer base. Excellent logistic management and customer service add to the appeal.

The feedback from Members

If the results from our Member Survey for 2021 are any indication, our stock recommendations, in combination with our big picture analysis, continue to be appreciated.

The daily email from Angus Geddes is a vital part of our communication with Members and a channel through which Fat Prophets provides clarity on our views on macro and micro-economic developments, and the implication for stock markets, in a timely manner. This was the year when the big (and the right) calls were appreciated more than ever.

The daily email was separately graded and received an 'A'. This is a testament to the value placed on the daily note by many Members. Our efforts on the Australian Equities research service have also been awarded an 'A' grade from Members for 2021, which we find a pleasing result given the many continued challenges the markets faced this year. This was a step up from 2020's 'A-'. As usual, there was plenty of dispersion with comments and constructive feedback.

This gives us areas to improve upon in 2022.

Our weekly research webinars continue to be well received. These sessions give Members the chance to hear direct from the Fat Prophets team. The forum style with a Q&A session at the end has also been a great way for us to engage with Members and the feedback here continues to be positive. We introduced a weekly podcast in 2021, where our founder and CEO Angus Geddes discusses the issues penned in his daily communiques with Members. The podcast is a great way for our Members to get an insight into Angus's views on key events through the week and was well received by Members. **We certainly look forward to 2022 and again getting into our weekly Members webinar and podcast.**

Members also remain receptive towards our weekly fatWRAP which summarises the ideas from across the Fat Prophets suite of research products. We continue to put plenty of thought into our covers and design, so it is pleasing that feedback here remains positive. Our Income Portfolio continues to have a following from those seeking a steady dividend, considering the abysmal offerings for cash in the bank.

We review the Income Portfolio quarterly and on the income side, it had a return to date of 22.1% at our review in October. This is lower than our last review and it should be noted that this is an average income return, which we view as solid, given the influx of new constituents over the past year. A re-rating in share price values saw the total return on the portfolio increase to 51.4% to 25 October 2021 versus 50.7% at our last update. The average yield (FY21) sat at 4.5% and is 4.7% for FY22 which is solid, given the share price appreciation that has been seen.

We will be publishing our predictions for 2022 in the next reports to be published in two parts; the first in the week beginning the 3rd of January 2022, and the second in the week beginning the 10th of January 2022. As usual, these predictions will cover a range of topics.

Signing off on 2021 and we would like to once again thank all Members for their continued support and wish all a safe and happy Christmas and a prosperous New Year.

Best regards,

Fat Prophets

Disclosure: Interests associated with Fat Prophets hold shares in BHP, Rio Tinto, Domino's, Collins Foods, Westpac, ANZ Bank, National Australia Bank, Bank of Queensland, Oil Search, Woodside, Telstra, HUB24, Praemium, QBE Insurance, James Hardie, Domain, Nufarm, Elders, Santos, Sydney Airport, Allkem (nee Orocobre), IGO Group, Whitehaven Coal, Fortescue and Adore Beauty.

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