

# Ellerston Equity Income KIS Fund

Monthly Newsletter, May 2023

## Investment Objective

The investment objective of the Ellerston Equity Income KIS Fund ("KIS" or "the Fund") is to provide investors with returns and income growth greater than the S&P/ASX 200 Accumulation Index over rolling 5 year periods.

## Investment Strategy

The Fund is a fundamental, bottom up, concentrated Australian equities strategy with a clear focus on delivering sustainable dividend income for investors through an actively managed portfolio of stocks throughout the market cycle.

## Key Information

Strategy Inception^^	1 May 2019
Portfolio Manager	Chris Kourtis
Application Price	\$1.0277
Net Asset Value	\$1.0251
Redemption Price	\$1.0225
Liquidity	Daily
No Stocks	30
Strategy FUM	\$31.8m
Management Fee	0.70% p.a.
Performance Fee	10%
Buy/Sell Spread	0.25% on application 0.25% on redemption
Minimum Investment	\$10,000
Minimum Additional Investment	\$5,000
Distribution Frequency	Quarterly

FY23(E) Key Portfolio Metrics	Fund	Benchmark
Grossed Up Dividend Yield (%)	8.1	5.7
Price/Earnings (X)	10.9	14.4
Dividend Yield (%)	6.3	4.4
Beta	0.87	1.00

## PERFORMANCE SUMMARY

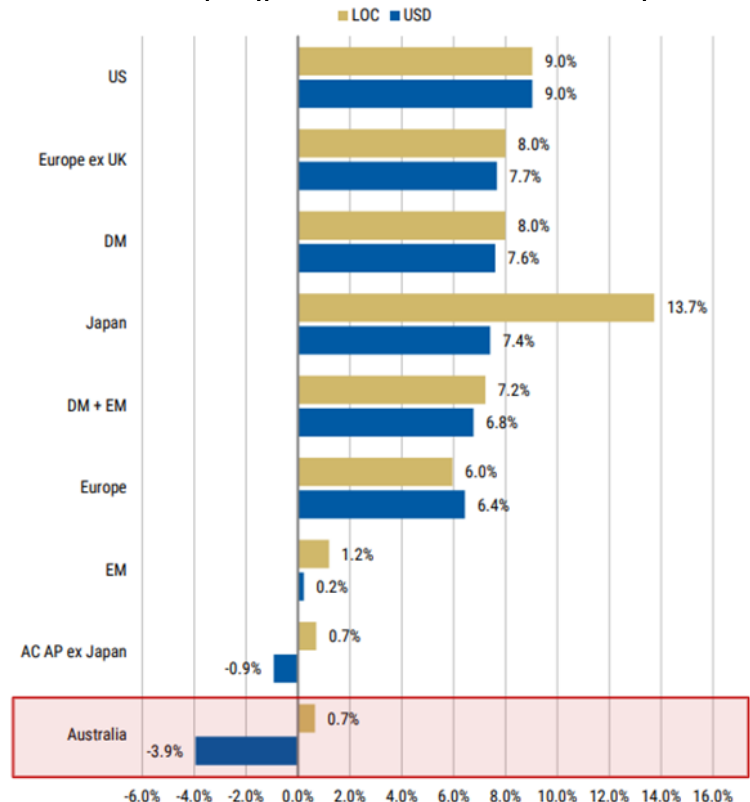
Performance	1 Month	3 Months	CYTD	FYTD	Rolling 12 Months	2 Years (p.a.)	3 Years (p.a.)	Since Inception (p.a.)^^
Net^	-2.21	-0.52	3.20	8.84	0.22	4.03	11.70	8.57
Benchmark*	-2.53	-0.89	2.71	12.80	2.90	3.87	11.43	6.89
Alpha	0.32	0.37	0.50	-3.96	-2.68	0.17	0.27	1.68

^ The net return figure is calculated after fees & expenses. Past performance is not a reliable indication of future performance  
\*S&P/ASX 200 Accumulation Index.

## MARKET OVERVIEW

The MSCI Developed Markets closed down 0.22% in May and the S&P 500 gained 0.4% in local currency terms. The prevailing market themes were AI optimism, the big tech rally and concerns over the US debt ceiling imbroglio. Against this backdrop, Emerging markets (+0.0%), marginally outperformed their Developed Market counterparts, with Information Technology, Communication Services and Consumer Discretionary being the best performing sectors globally. The domestic market finished at 7,091pts, down 2.5% for May, with both Materials (-4.4%) and Financials (-3.2%) acting as a heavy barbell.

MSCI Global Country/Regional Indices Performance for May 2023 CYTD



Source: Morgan Stanley.

## USA

Key economic indicators continued to weaken, however employment data remained elevated and inflationary pressure rose marginally. US April Non-Farm Payrolls rose 253k, higher than consensus of 180k, versus a previously revised number of 165k, with the unemployment rate down to 3.4%. The Core Personal Consumption Expenditure (PCE) price index, the US Federal Reserve's (Fed) preferred inflation measure, came in higher than expectations, rising to 4.7% YoY from 4.6%. As expected, the Fed increased official rates in early May by 25bps to a range of 5.00%-5.25%. Fed Governor and vice chair-designate, Phillip Jefferson raised the chances for a pause in rate hikes at the next Federal Open Market Committee (FOMC) meeting in mid-June, but emphasised that "it should not be viewed as the end of the tightening cycle".

May was all about the AI juggernaut, propelling the NASDAQ Composite Index by 5.9% for the month and clocking up an impressive +24.1% return for the CYTD! The S&P 500 caught some of the AI tailwind, finishing up 0.4%, however the Dow Jones Industrial Average was the clear laggard, posting a disappointing 3.2% fall.

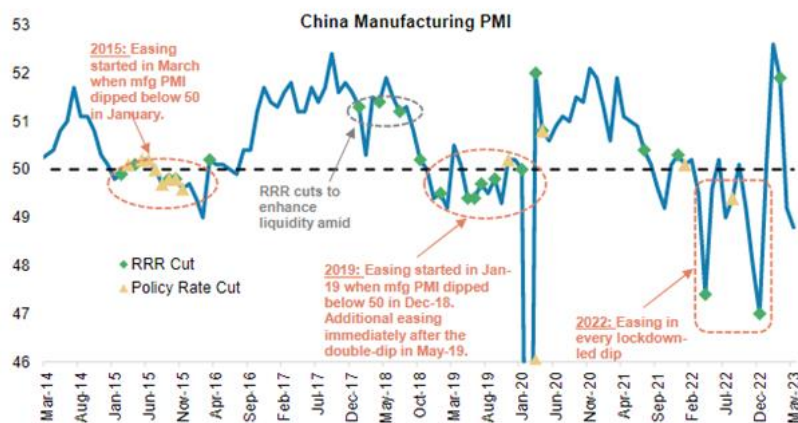
## Europe

Eurozone economic indicators were generally soft, with the composite PMI falling to a three-month low of 53.3 in May. The services sector however, continued to show a robust performance, while manufacturing activity contracted at a much faster pace. A bright spot was the decline in Eurozone headline inflation from 7.0% to 6.1% in May, with core inflation down to 5.3% from 5.6%. Despite this, the European Central Bank (ECB) seems essentially committed to another 25bps hike on 15 June, given the stubbornly high underlying price pressures.

The Euro STOXX50 Index finished the month down 2.2%. Among the major exchanges, Germany's DAX was 1.6% lower, France's CAC 40 fell 4.2% and UK's FTSE 100 was the clear laggard, -4.9%.

## Asia

After two consecutive months of weak China manufacturing indicators – the May manufacturing PMI slipped by 0.4ppt to 48.8, the softest reading since the reopening. Weakness in manufacturing has historically been a solid precursor to policy easing.



Source: Morgan Stanley

Asian equity markets were mixed. The Nikkei 225 was the standout at +7.0%, Korea's KOSPI rose 3.0% and India's SENSEX was up 2.9%. China's SSE fell 4.9% and the Hang Seng slumped 7.9%.

## Commodities

Commodities were much weaker in May amid hard landing concerns, a stronger US dollar and a sluggish Chinese economy. Gold was again the best performer, falling just 1.4% to US\$1963 per ounce. Thermal coal fared the worst, down 27%, in line with weaker global gas prices (LNG JKM price was down 20%), impacted by lower demand, the result of warmer northern hemisphere weather. The Brent oil price fell 9% to US\$73/barrel on lower demand expectations. Iron ore and coking coal prices ticked down 3% to US\$103 and US\$224 per tonne, respectively. The base metals complex was very weak, with the major metals; aluminium down 3%, copper down 6% and both nickel and zinc down 16%. On the bright side, lithium carbonate bounced back strongly, up 60%, as inventory destocking ended. However, spodumene prices fell a further 15%, as the upstream part of the inventory chain is typically the last to normalise.

## Bonds

The US 10-year treasury yield rose 23bps to 3.65% in May. Concerns over regional bank liquidity and the sector's viability lessened and positioning for the Fed to start cutting rates later this year faded away, with little support from the unfriendly inflation data. The Australian 10-year bond yield was up 26bps to 3.60%, as the Reserve Bank of Australia (RBA) surprisingly hiked official rates by 25bps in early May to 3.85%, after only pausing for one month.

## Australia

The A\$ closed the month only marginally lower at US\$0.65, against the backdrop of a stronger US dollar and weaker commodity prices.

In the month of May, the S&P/ASX 200 Accumulation Index finished down 2.5%, dragged down by materials, consumer discretionary and banks. The Information Technology sector (up 11.6%), was the best performer (the biggest contributors were Xero +17.8%, and Wisetech Global +9.1%), followed by Utilities (+1.1%) and then Energy (+0.2%). The bottom three sectors were Consumer Discretionary (-6.1%, pulled down by Wesfarmers, -8.3%), Consumer Staples (-4.6%) and Materials (-4.4%).

For the month, the top stocks that made a positive contribution to the Index's return were CSL (+13bps), Xero (+11bps), James Hardie (+9bps), Allkem (+7bps) and Woodside Energy (+5bps). Conversely, the bottom five stocks detracting from the Index's performance were BHP (-55bps), NAB (-30bps), Wesfarmers (-23bps), CBA (-21bps) and Westpac (-18bps). The ASX Small Ordinaries fell 3.3%, underperforming the broader benchmark by 0.7%. Within the ASX Small Ordinaries, the Small Industrials outperformed at -1.7%, with the best performer being tech company Life360 up a whopping 34.1% - see the "hits" write-up below. Software and Services was the highest returning sub-industry group, rallying +12%, driven by its largest component Xero, where the accounting enterprise software business delivered a better than expected FY23 result, see write-up below.

## COMPANY SPECIFIC NEWS

### The Market Hits

#### Life360 (360 +34.1%)

360 is a global family safety service technology company that aims to protect people, pets and items by utilising live location sharing via a mobile application. It reported very strong Q1 results in May, with revenue of \$68m up an impressive 34% on pcp. More importantly, the core subscription revenue of \$46m was 66% higher and 360 also surprisingly delivered positive EBITDA of \$0.5m, one quarter ahead of their expectations. Investors reacted positively, pushing up the stock price by 12% on the day and the global tech rally tailwind did the rest.

#### Lake Resources (LKE +26.2%) / Allkem (AKE +21.2%)

Lithium producers AKE and US based Livent announced plans to merge in an all-stock merger of equals, forming a new company with an implied market capitalisation of ~US\$10.6bn. Key drivers of the merger are: 1) business critical scale (becoming a global a top 3 lithium producer), 2) value-adding vertical Integration, and 3) accelerated growth. The merged company will be positioned with a strong pipeline of highly complementary growth projects enabling the acceleration and de-risking of these projects across, carbonate, hydroxide and other opportunities whilst also driving the production capacity from ~90ktpa CY23 to ~250ktpa in CY27 (inclusive of the current growth pipeline). AKE and Livent estimate the merger should unlock ~US\$125mn in annual run rate synergies and ~US\$200mn in one time capex savings in the first 3 years. AKE shareholders will own 56% of shares in the new company, post the shareholder approval expected in Oct/Nov this year. The announcement propelled AKE's shares by 15.7% on the day of the announcement and also lit up the lithium sector, which was also helped by the ~60% recovery in lithium carbonate prices during the month, albeit spodumene prices were flat. Lithium hopeful LKE is a case in point, after falling 80% from its March 2022 high it had the biggest bounce versus its peers, nearly all of price rise in the two days after the AKE announcement.

#### Megaport (MP1 +21.1%)

MP1 continued its strong performance after a very strong 3Q23 report in late April, this month catching the all-engulfing AI tailwind spearheaded by the AI poster boy, Nvidia Corporation. NVDA's stock price closed up 36%, following a quarterly update that smashed the Street's estimates. The move added an eye-watering US\$250bn in market cap for the month.

#### Xero (XRO +17.8%)

Just as the global tech sector got hammered in CY22 and XRO fell 50%, this year's strong tech performance has seen XRO rebound 55% for the CYTD. XRO's new CEO reported a better than expected FY23 result, with a 7% beat on underlying EBITDA, stronger cash flow and pleasing investors the most, better cost outcomes. It also reported lower churn (which remained at 0.9%), improved ARPU of 10% and stronger subscriber growth in all regions (excluding Australia). Investors really liked the new CEO's focus on profitability, with a reaffirmed target of 75% cost to income ratio (FY23: 80.7%). Her reinforced pledge that XRO will be "more balanced and look to the Rule of 40 as a useful performance evaluation measure in managing the balance of growth and profitability" resonated. As a reminder, the rule of 40 dictates that the free cash flow margin and the revenue growth rate of a business should equal to at least 40, although no timing was provided. XRO was up 9% on the day and squeezed higher during the rest of May.

#### Lynas Rare Earths (LYC +16.8%)

Much to everyone's surprise, LYC was granted a 6-month extension to continue cracking and leaching at its Kuantan plant in Malaysia, after the company had been vocal in its lobbying and going through legislative appeals seeking this outcome. This now gives LYC the time to ramp up its Kalgoorlie facility and provide Kuantan with a mixed rare earths concentrate from January 2024. This also allows LYC to increase the throughput of the plant, which is currently capped at approximately 6ktpa of NdPr. Investor expectations was for no extension to occur, with sell side analysts baking in a shut-down at the Malaysian plant, anytime from 3 to 12 months in their forecasts. Now that the hiatus in production was averted, there were significant earnings, cash flow and valuation upgrades across the board for LYC post the announcement, pushing up the stock price 12% on the day.

#### Telix Pharmaceutical (TLX +15.3%)

Back in April, TLX posted a strong 1Q23 update with Illuccix sales up 28% QoQ to A\$100m, positive operating cash flow and a healthy cash balance of \$121.4m). Investors liked the fact that sales momentum was finally providing a pathway to profitability metrics, resulting in a powerful short covering squeeze in the name and propelling the stock 47% to the top of the "hits" league table. This month, there was little news from the company, but the momentum continued, although at a slower pace.

#### James Hardie Industries (JHX +13.1%)

JHX did well after reporting a much better than feared and strong 4Q finish to a very challenging FY23. JHX delivered a high-quality result, with adjusted net income of US\$606m. This was in line with the company's guidance (US\$600-620m) and Visible Alpha Consensus (US\$603m). While JHX expects a sharper fall in volume in the year ahead, 1Q24 guidance confirmed a good start to the year, with price/mix and margins remaining firm at this point in the cycle.

The sequentially stronger 4Q (US\$146.2m) was driven by better than expected North American (29.0%) and APAC (28.9%) margins, excluding undisclosed NZ legal settlement costs. On this occasion, JHX understandably departed from its traditional full-year outlook guidance, reverting to 1Q only (given broader end-market demand uncertainty and a relatively new CEO keen to reset expectations). The company applied the low end of ranges provided, resulting in management forecasting a US total addressable market volume decline

between -14% and -19%. Pleasing the market further, management expressed confidence in growing net average sales prices (ASP). This was partly on the back of absolute price hikes and part favourable mix towards higher priced, more repair and remodel exposed products e.g. Architectural, ColorPlus. Elsewhere, capex of US\$550m looked materially higher than consensus of US\$414m, but investors brushed this aside and the stock charged ahead.

### **AGL Energy (AGL +13.1%)**

The AER and ESC (Victorian regulator) released the finalised Default Market Offer (DMO) and Victorian Market Offer (VMO), effectively locking in tariff increases for FY24. The top-line tariff increases were predominantly driven by the higher wholesale electricity pricing cost allowance, which was increased by ~50-90% across the east coast of Australia and broadly in-line with the previously released draft estimates. The stronger wholesale cost allowances are a positive for both AGL and Origin Energy. AGL has a large electricity generation portfolio underpinned by coal and gas-fired generators, helping the company retain a relatively more fixed (vs its competitors) wholesale generation cost. In a rising energy price environment, this should improve its electricity gross margins. AGL maintains a strong coal supply position, enabling it to provide some of the lowest cost base load electricity in the market. With the Origin takeover near completion, AGL is the only way for investors permitted to own stocks that source power from burning coal, to take advantage of the higher power prices.

## **The Market Misses**

### **Syrah Resources (SYR -26.0%)**

Graphite producer and perennial disappointment SYR continued its run of poor market performance, with its stock price now down 58% CYTD. SYR put out yet another disappointing "dog ate my homework" Q1 activities report on 27 April, which showed a less than expected production improvement from its Balama mine in Mozambique. Together with higher unit costs and lower selling prices, again the result was the business was operating in cash losses. SYR highlighted tough Chinese anode market conditions, which it expects to be volatile over the near-term. Forward sales orders for Balama products have weakened further from the higher levels seen in the market in 2022. This, coupled with the availability of significant finished product inventory, has led Syrah to announce that it will moderate production from Balama until demand conditions and sales orders at economic prices warrant higher capacity utilisation. The Company's cash balance at 31 March 2023 was US\$84 million, which included unrestricted cash of US\$48m. SYR tapped its major 17% shareholder AustralianSuper, for the issuance of new convertible notes to provide the company with urgently needed additional liquidity to manage near-term demand volatility for Balama natural graphite. This was a drag on SYR's stock price throughout May, with no signs of light at the end of the tunnel. The shares closed at 88.5cents, a far cry from their highs of \$5.65 back in 2016, when investors had high hopes for the prospects of this fledgling graphite producer.

### **Ooh!media (OML -25.8%)**

OML shares tumbled as much as 40% intra-day, the most since August 2019, after updating the market at the Macquarie conference on May 3. The company's presentation and trading update noted that advertising revenue softened significantly towards the end of the March quarter and that April media revenue was pacing at -10% YoY. Analysts subsequently slashed their earnings based on tender renewals and legacy contracts in NZ expected to result in GP margin compression into FY23/24 (falling from last year's 46.2% outcome).

### **Lovisa Holdings (LOV -22.5%)**

Women's fashion jewellery and accessory supplier LOV got thumped, as did other discretionary retailers, immediately after the surprising increase in the RBA cash rate after only one month's pause. LOV performed worse than its peers, which is in many ways understandable given the nose bleeding high altitude of its FY23 PE at 30x, three times the valuation of the other listed consumer discretionary retailers.

### **IDP Education (IEL -22.5%)**

IEL engages in the placement of students into educational institutions in Australia, the UK, US, Canada, New Zealand and Ireland. Examinations, particularly the English test eligibility requirements for student visa applications (via IELTS) is a major proportion of the company's revenue. Late in May, the Canadian government announced that effective mid-August 2023, the English language test eligibility requirements for student visa applications under its Student Direct Stream (SDS) program will be extended to include IELTS, plus Pearson Test of English (PTE), CELPIP, CAEL and TOEFL. Previously, IELTS was the only eligible English language test under Canada's SDS program. The impact on IEL is that it puts a significant proportion of its ~2m IELTS under new competitive pressure, certainly in Canada. Furthermore, there may be flow-on impacts to IEL's broader IELTS in the rest of its markets - as key IELTS agreements can be terminated with 12 months' notice. Investors were shocked by the news announcement and didn't like the uncertainty of trying to quantify the potential market share losses. The company's trite response "that the IRCC'S decision would not materially impact FY23 revenue or earnings" following the ASX price query offered no consolation or clarity on FY24, given the decision to recognise additional providers for the visa scheme would only be effective from 10th Aug 2023.

### **Whitehaven Coal (WHC -21.4%)**

WHC suffered from the 27% collapse in thermal coal prices during the month. The sharp pull-back in steaming coal was in line with the drop in global gas prices, given the warmer than normal northern hemisphere winter.

### **Elders (ELD -18.3%)**

Elders negatively surprised and delivered a soft profit result, with 1H23 EBIT of \$83m (vs. consensus \$96m), which was down 38% vs. pcp. The miss was driven by a larger than expected \$30mn "strategic investment" in non-COGS operating costs, most notably headcount and "transformational" projects. Elders added 250 people in 1H23, mainly comprising +116 network expansion, +57 acquisitions and +29 transformation projects. This cost investment drove a sharp increase in the cost-to-earn ratio to 73% vs. 1H22 59%. 1H23 performance was also impacted by softer livestock trading conditions, weaker crop input prices and unseasonably wet weather. Operating cash performance was weaker than expected, with an outflow of \$87m. Whilst this was in-line with typical cash flow seasonality, it represented the third consecutive result of poor cash generation. Elders management provided earnings guidance, stating it expected to deliver FY23 EBIT of between \$180-200mn, implying a 2H23 EBIT of \$107m at the mid-point, or a +28% uplift vs. 1H23. This sequential improvement should be underpinned by: (1) \$18m benefit from a reduction in cost-to-serve to 67%, (2) \$11m increase in Rural & Wholesale Products earnings given the return to more typical 2H seasonal skew in farmer purchasing of chemical products, and (3) \$3m improvement in Agency earnings to account for improved cattle volumes through Elders sale yards. The FY23 result clearly represents a rebasing year following an extraordinary FY22, which still represents a respectable 27% CAGR since FY19, but the market didn't care and clubbed the stock.

**Perseus Mining (PRU -18.2%) / Silver Lake Resources (SLR -17.7%) / De Grey Mining (DEG -17.0%)**

Gold's stock were under the pump during the month after the bullion price peaked at US\$2050/ounce early in May, but finished down at US\$1963/ounce, pushing the gold sector down 8% in sympathy. The rebound in US bond yields drove the US\$ higher, which acted as a drag on the gold price. Developer DEG fared the worst, given the company needs to fund its Mallina gold project in Western Australia, a task to raise potential equity made harder in a falling gold price environment. During the month, SLR made three attempts to acquire St Barbara Mines Leonora gold assets in Western Australia. The cash component of the deal (which matched the rival offer from Genesis Minerals) was lifted from \$326m to \$370M, yet it was still rebuffed, which wasn't taken kindly by SLR Investors. PRU is the higher sovereign risk leveraged stock to own when gold is tearing and vice versa when it's not. Investors' appetite quickly waned, as expected returns diminish, but the risks remain the same - the company has gold mines in Ghana, Cote d'Ivoire and Sudan...say no more.

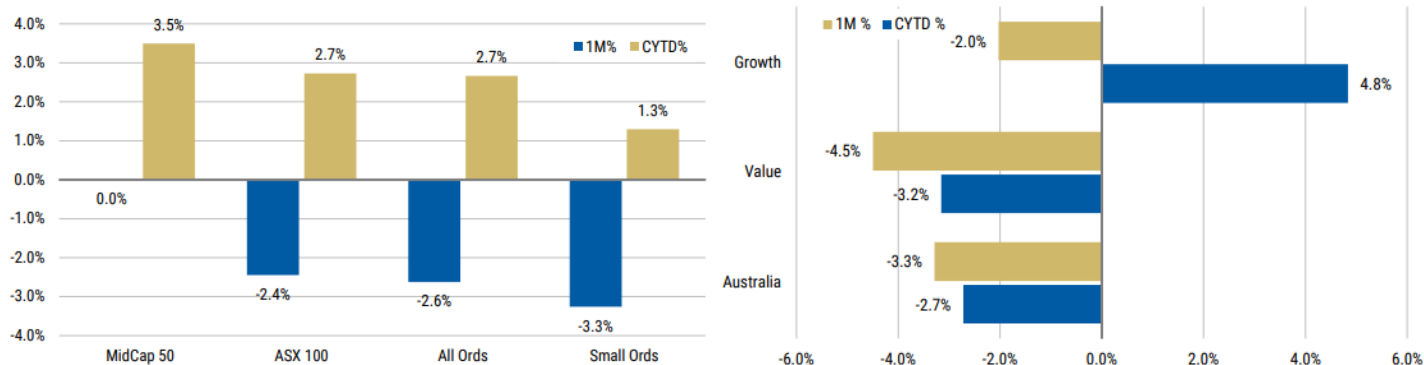
## FUND PERFORMANCE

Global macro influences and volatility stayed elevated during May, while the barbell of Consumer Discretionary (on signs of a weaker consumer), Financials and Materials (mainly BHP) drove the market 2.5% lower over the month. Technology was the clear stand out, obviously leveraging offshore leads in big cap Tech and AI. Value as an investment style also underperformed Growth (+2.5) yet again, with growth being driven by the tech stalwarts.

Pleasingly, despite owning no outperforming tech darlings the likes of Xero, WiseTech or NEXTDC which ripped, we remained true to label, and the Fund return of -2.15% still managed to outperform the benchmark return of -2.53%.

Whilst the Fund has kept pace with the market for the CYTD, it has proven more difficult to outperform for the FYTD with no tech exposures. The Xero's and Wisetech's in the benchmark pay zero or very little by way of dividends. As an income fund, we need to navigate between the dividend flags and stay true to label.

Mid-Cap and Small-Cap stocks continued to close the gap with their Large Cap peers CYTD, although small caps were the worst performers for the month of May.



Source: Morgan Stanley

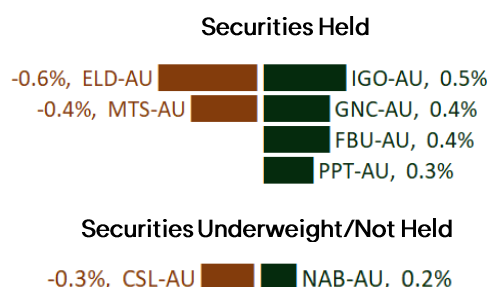
Information Technology, which rose 11.6%, posted the largest contribution to the market's return in May (led by Xero +17.8%), followed by Utilities (AGL Energy +13.1%) and Energy (Woodside Energy +1.8%).

Financials and Consumer Discretionary were two of the three worst contributors to the market's return, with Materials faring the worst, closing down 4.4% (dragged down by iron ore miners BHP -5.4% and Fortescue Metals -8.2%).

Returns <sup>1</sup> (%)	Gross	Benchmark	Excess	Net Return
<b>1 Month</b>	-2.15	-2.53	0.38	-2.21
<b>3 Months</b>	-0.35	-0.89	0.54	-0.52
<b>CYTD</b>	3.50	2.71	0.79	3.20
<b>FYTD 2023</b>	9.58	12.80	-3.22	8.84
<b>Rolling 12 Months</b>	1.06	2.90	-1.85	0.22
<b>2 Years (p.a.)</b>	5.12	3.87	1.25	4.03
<b>3 Years (p.a.)</b>	12.76	11.43	1.33	11.70
<b>Since Inception (p.a.)</b>	9.70	6.89	2.80	8.57

<sup>1</sup> The return figures are calculated using the redemption price and on the basis that distributions are reinvested. The Gross and Excess return figures are before fees and expenses whereas the Net Return figures are net of fees and expenses. Returns of the Fund may include audited and un-audited results. Past performance is not a reliable indicator of future performance.

## Month of April Attribution



Source: Ellerston Capital.

In May, the main positive contributors were active overweight positions in IGO (IGO +3.7%), GrainCorp (GNC +12.2%), Fletcher Building (FBU +10.2%), Perpetual (PPT +0.9%), Ampol (ALD +4.9%) and a zero holding in NAB (NAB -7.1%).

The main detractors for the month were our overweight positions in Elders (ELD -18.3%), Metcash (MTS -9.0%) and not holding CSL (CSL +1.9%).

## FUND ACTIVITY

The Fund was again quite active during the month of May, taking advantage of the market volatility to strengthen select existing positions in Fortescue Metals, Insignia Financial, Incitec Pivot, Regis Healthcare and Santos. We also introduced four new names, APM Human Services, Aurizon Holdings, Ramsay Health Care and Treasury Wine Estates (post the downgrade to FY23 guidance). We funded these purchases by taking profits and reducing positions in Bega Cheese, Fletcher Building, IGO, and Iluka. We also profitably exited Wesfarmers and Woodside Energy and our residual holdings in Eagers Automotive, QBE Insurance and The Lottery Corporation.

### NEW STOCKS ADDED

- APM Human Services
- Aurizon Holdings
- Ramsay Health Care
- Treasury Wine Estates

### STOCKS EXITED

- Eagers Automotive
- QBE Insurance Group
- Wesfarmers
- The Lottery Corporation
- Woodside Energy

### INCREASED

- Fortescue Metals
- Insignia Financial
- Incitec Pivot
- Regis Health Care
- Santos

### DECREASED

- Bega Cheese
- Fletcher Building
- IGO
- Iluka

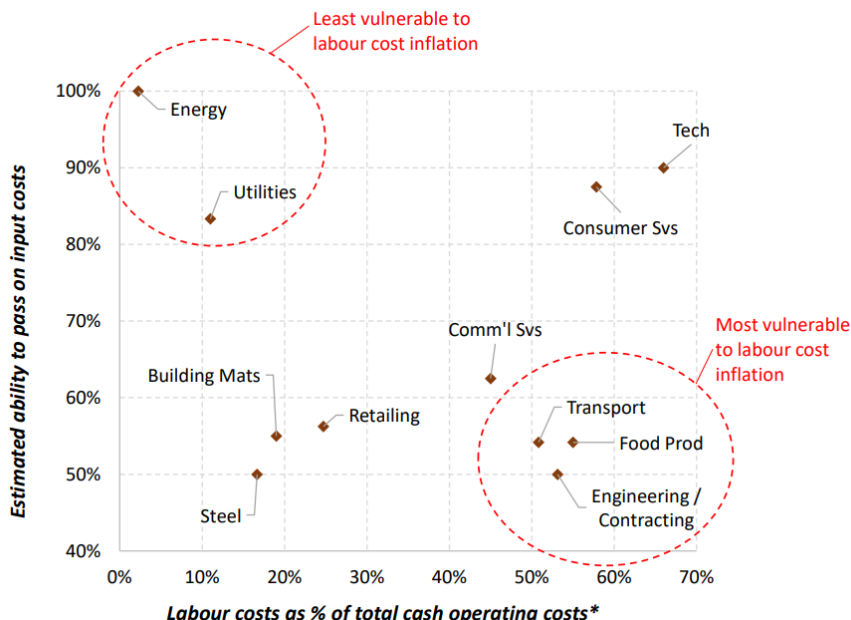
## FUND STRATEGY AND OUTLOOK

Not surprisingly, the Federal Open Market Committee (FOMC) meeting on the 2-3 May increased the Fed Funds rate by 25bps to a range of 5.0-5.25%, making it 500bps of rate increases in a little over 12 months. For the pending Fed meeting in June, the bond market implied pricing flipped from another 25bps rise after the hot PCE deflator reading, to the possibility of pause, after vice chair-designate Phillip Jefferson's comments that a "skip to take in the impact of the rate hikes to date" might be in order. He added, "however, it doesn't mean the end of the tightening cycle". We will find the answer in mid-June.

The circus, which is the raising of the US debt ceiling, came to its usual cliffhanger result, with the required last minute bipartisan negotiators striking a deal to once again avert a default. The equity and bond markets paid little notice, as there is usually a reprieve to ensure that hundreds of thousands of government jobs aren't temporarily lost. Since 1960, Congress has increased the ceiling seventy-eight times, most recently in 2021. The US Senate gave the final seal of approval to lift the \$US31.4 trillion debt ceiling on 2 June, with three days to spare.

Back at home, Australian workers have secured the largest pay increase in decades, with the Fair Work Commission announcing a 5.75% increase in the National Minimum Wage, which applies to ~1% of all employees and more importantly, a 5.75% increase to the Average Award Wage floor, which applies to ~25% of employees. This will add to inflation pressures, increasing the chances of further rate rises by the RBA. It will also put pressure on profit margins for companies with a high mix of minimum wage and award wage earners, where wages comprise a large proportion of their overall operating costs, and make it more challenging to pass on these higher wage costs in order to maintain profit margins.

## Labour expense as a % of business costs and ability to pass on cost by ASX Sectors



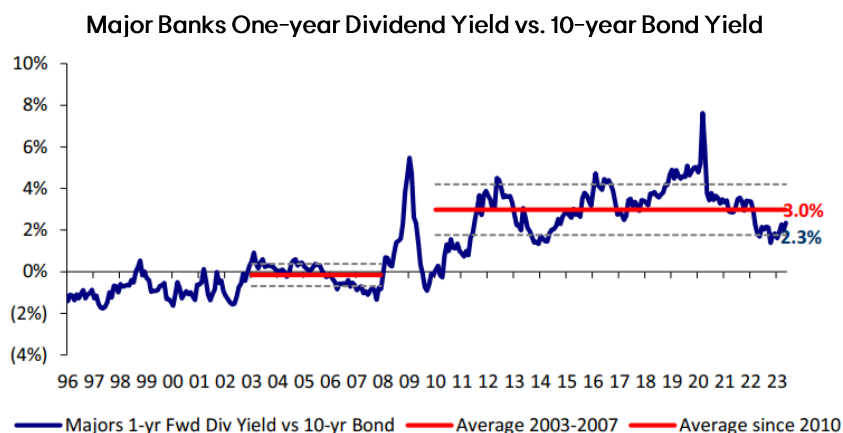
Source: UBS

The RBA's 25bps rate hike caught everyone off guard, after only pausing for a single month. After a higher than expected CPI print domestically, the probability has swung to another 25bps point rise to 4.1% in early June. However, after the last move by Governor Lowe, anything is possible. The take-out from recent corporate updates and retail sector channel checks is that the consumer's appetite has started to wane in response to 11 rate hikes. The higher cost of living, particularly rents, is also hampering consumer discretionary spending.

Growth as a Style has staged a strong recovery and the Value trade has been temporarily smoked by the AI frenzy, which has propelled the tech stalwarts. A Russell 1000 subindex, made up of the likes of Energy, Materials and Financials has trailed a counterpart pegged to growth stocks by the most in over 20 years.

From a sector perspective, the Big 4 retail banks underperformed the Australian market in the month of May. The average major bank total shareholder return (TSR) of -4.3% in May was worse than the ASX200 (-2.5%). ANZ and CBA were broadly in line with the market, while NAB was the worst (ANZ -2.6%, CBA -2.6%, NAB -7.1% and WBC -4.9%). Since the start of the current RBA tightening cycle, P/E multiples have de-rated by an average of ~3.2x (ANZ ~2.5x, CBA ~2.5x, NAB ~3.8x, and WBC ~3.6x). Given intense competitive pressures in deposits and mortgages and the fact that NIM's peaked in Oct 2022, the risk of a further de-rating is clearly on the cards if expectations for the RBA's cash rate shifted higher. We also note that an RBA pause tends not to have a large impact on the banks' P/E multiples, but historically, rate cuts usually drive a material re-rating. **The impact of rate rises on Australian loan and deposit growth will become clearer in the September quarter, but in the meantime, we expect the majors will want to protect market share.**

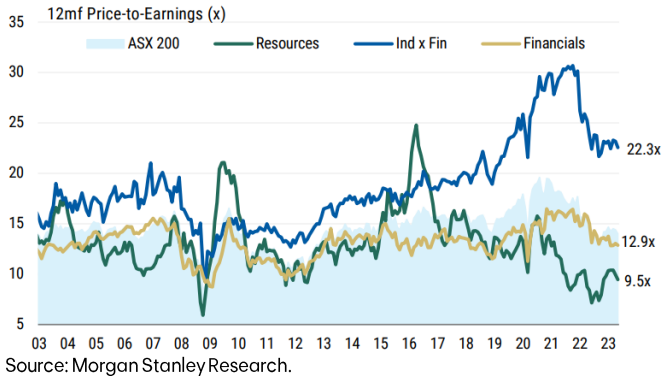
Bank forward dividend yield of ~6.2% compares with a post-2010 average of ~6.0%, however, relative to current bond yields the banks look expensive.



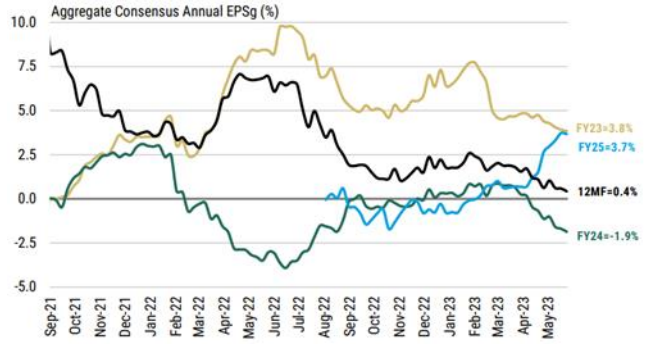
The domestic market multiples which had de-rated meaningfully over the past year, have reversed somewhat in the past few months (as the market bounced sharply off its lows), with the 12MF P/E now standing at 14.0x. Outer year earnings growth forecasts remain fairly anchored in very low-single-digit territory.



**Valuation: the 12M forward PE of the Industrials ex-Financials has Fallen from 30.2x to 22.3x**



**Annual Consensus EPS Growth Trends FY23-25**

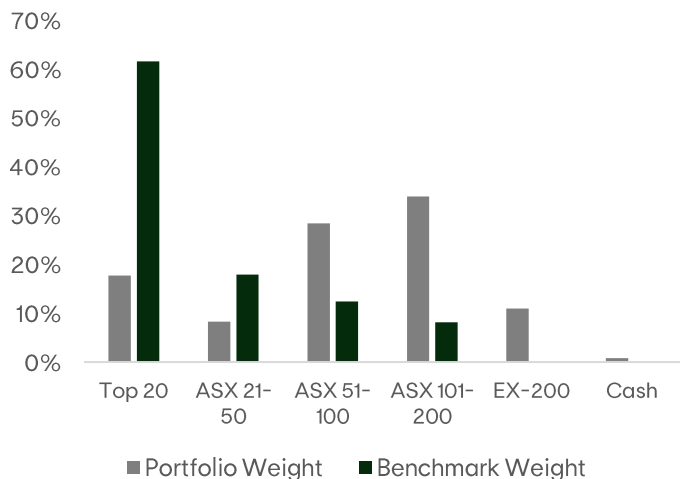


Apart from the broad changes outlined in the Activity Section, the Fund strategy remains as per last month and we are holding the course.

We remain true to label.

The grossed up dividend yield on the portfolio now rests at 8.1%, which remains superior to the market dividend yield, despite owning no Banks, Telstra, and other traditional income payers.

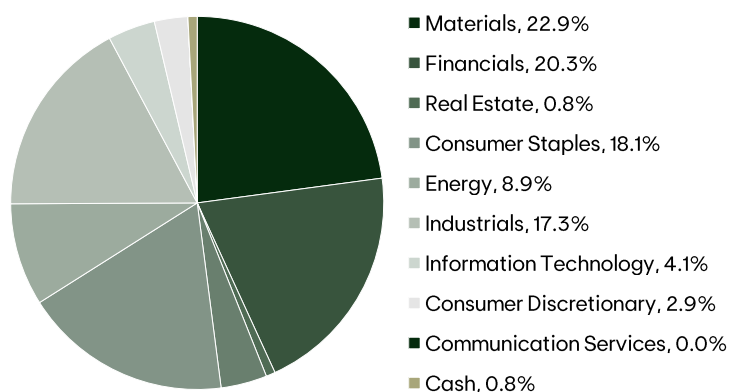
## MARKET CAPITALISATION



## TOP 10 HOLDINGS

ATLAS ARTERIA	9.67%
PERPETUAL	8.81%
BHP GROUP	8.72%
INSIGNIA FINANCIAL	6.27%
METCASH	5.63%
LIBERTY FINANCIAL GROUP	4.76%
SANTOS	4.62%
FORTESCUE METALS GROUP	4.34%
AMPOL	4.25%
IRESS	4.12%

## SECTOR ALLOCATION



Source: Ellerston Capital.

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### Find out more

**For new or additional applications into the Fund, please click [here](#).**

**The Fund is also available for application through the NetWealth and HUB24 Platforms.**

All holding enquiries should be directed to our register, Automic Group  
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Should investors have any questions or queries regarding the Fund, please contact our Investor Relations team  
on **02 9021 7701** or [info@ellerstoncapital.com](mailto:info@ellerstoncapital.com) or visit us at [ellerstoncapital.com](http://ellerstoncapital.com)

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