



BKI INVESTMENT COMPANY

ABN: 89 615 320 262

June 2023



BKI is managed by Contact Asset Management
AFSL 494045

QUARTERLY REPORT

What Goes Around Comes Around

Welcome to the 38th edition of the BKI Quarterly Report, prepared by Contact Asset Management (“Contact”).

Rising global inflation is continuing to challenge the resilience of corporations and investors alike. We wrote in our June 2022 Quarterly Report that “inflation has become the dominant topic of our daily news”. After eleven rate hikes from the Reserve Bank of Australia (RBA), taking our cash rate from 0.10% to 3.85%, it appears the topic of inflation drums are beating louder and louder. A year ago, the RBA was hoping that it could quickly burst the inflation bubble and settle rates below 3.50% by mid-2023. We are now there. Following the latest CPI data, where CPI for April increased at an annualized 6.80% yoy we thought to revisit this topic, especially as rates have passed 3.50% and headed towards target rates of between 4.00% and 4.50%. Although 6.80% was well above market expectations, it still appears that Central Bankers remain convinced that economies are strong enough to handle the rate increases and then some. While higher rates from here are a significant percentage increase from the pandemic low-rate environment, a rate of 4.00% to 4.50% is still very accommodative in a historical context.

In this Quarterly Report, we seek to learn from the past. We cast our eye back to August and September 2008. In August 2008 Australian Cash Rates peaked at 7.25% before the first of six rate cuts where the cash rate fell from 7.25% to 3.00%. The statements make for interesting reading given the current factors at play and it appears from these minutes, like most cycles, what goes around comes around.

Statements by Glenn Stevens, Governor: Monetary Policy

When the following two statements from RBA Governor Glenn Stevens are read, there are striking similarities between these periods and what is occurring in the current economy. These two notes could quite easily be released today, and you’d be none the wiser. We believe that the Australian market in 2023 differs greatly from global markets, just as it did back in 2008. Despite the widely discussed headwinds, the Australian market once again looks attractive relative to global peers.

Statement by Glenn Stevens, Governor: Monetary Policy

Media Release Number 2008-12

5 August 2008

At its meeting today, the Board decided to leave the cash rate unchanged at 7.25 per cent.

Inflation in Australia has been high over the past year in an environment of limited spare capacity and earlier strong growth in demand. This was evident again in the most recent CPI data. In these circumstances, the Board has been seeking to restrain demand in order to reduce inflation over time.

As a result of increases in the cash rate last year and early this year, additional rises in market interest rates and tougher credit standards, there has been a substantial tightening in financial conditions since the middle of 2007. Some further tightening has occurred over the past couple of months. Conditions in international financial markets remain difficult, with heightened concerns over credit persisting.

The evidence is that the tightening in financial conditions, in conjunction with other factors including rising fuel costs, and lower asset values, has restrained demand. Indicators of household spending have continued to record subdued outcomes over recent months, and credit expansion to both households and businesses has slowed significantly. Surveys suggest a softening in business activity, and there have also been some early signs of an easing in labour market conditions.

The rise in Australia's terms of trade that is currently occurring is working in the opposite direction, adding substantially to national income and ability to spend. At the same time, high prices of oil and a range of other commodities have added to global inflationary risks. They are also dampening growth in a number of countries.

Given the opposing forces at work, considerable uncertainty has surrounded the outlook for demand and inflation. On balance, however, it is looking more likely that demand will remain subdued, and economic growth will be fairly slow, over the period ahead. Inflation is likely to remain relatively high in the short term, with the CPI affected by high global oil prices. Looking further ahead, inflation in both CPI and underlying terms is likely to decline over time, given the outlook for demand, provided wages growth remains moderate. The Bank's forecast remains that inflation will fall below 3 per cent during 2010.

Weighing up the available domestic and international information, the Board judged that the cash rate should remain unchanged this month. Nonetheless, with demand slowing, the Board's view is that scope to move towards a less restrictive stance of monetary policy in the period ahead is increasing.

Statement by Glenn Stevens, Governor: Monetary Policy

Media Release Number 2008-14

2 September 2008

At its meeting today the Board decided to lower the cash rate by 25 basis points to 7.0 per cent, effective 3 September.

Inflation in Australia has been high over the past year in an environment of limited spare capacity and earlier strong growth in demand. In these circumstances, the Board has been seeking to restrain demand in order to reduce inflation over time.

As a result of increases in the cash rate last year and early this year, additional rises in market interest rates and tougher credit standards, financial conditions have been quite tight. Some further tightening has occurred over the past couple of months. Conditions in international financial markets remain difficult, with heightened concerns over credit persisting.

The evidence is that the tight financial conditions, in conjunction with other factors including higher fuel costs and lower asset values, have exerted the needed restraint on demand. Indicators of household spending have recorded subdued outcomes over recent months, and credit expansion to both households and businesses has slowed. Surveys suggest a softening in business activity and growth in production has slowed. Indicators of capacity utilisation, while still high, are declining and there have also been some signs of an easing in labour market conditions.

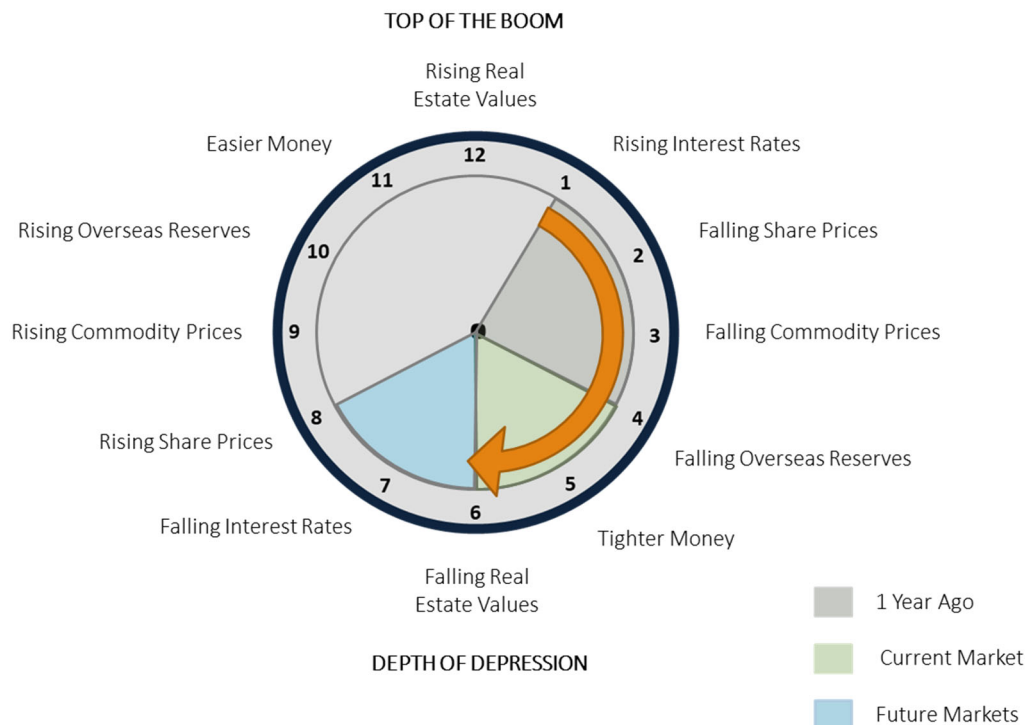
The rise in Australia's terms of trade that has occurred is working in the opposite direction, adding substantially to national income and ability to spend. Fixed investment spending by businesses continues to be very strong. At the same time, high prices of oil and a range of other commodities have added to global inflationary risks. They are also dampening growth in a number of countries.

Given the opposing forces at work, considerable uncertainty has surrounded the outlook for demand and inflation. On balance, however, it is looking more likely that household demand will remain subdued and overall economic growth slow over the period ahead. Inflation is likely to remain relatively high in the short term, with the CPI affected by the high global oil prices in mid year and other increases in raw materials prices. But looking further ahead, the outlook for demand suggests that inflation in both CPI and underlying terms is likely to decline over time, provided wages growth remains contained. The Bank's forecast remains that inflation will fall below 3 per cent during 2010.

Weighing up the available domestic and international information, the Board judged that there was now scope for monetary policy to become less restrictive. The Board will continue to assess prospects for demand and inflation over the period ahead, and set monetary policy as needed to bring inflation back to the 2–3 per cent target over time.

What Goes Around Comes Around

Over the last year, we've been watching the Investment Clock with interest. We believe we are almost through the cycle and while the term "Depth of Depression" sounds a little overcooked, this point in the cycle should provide the long-term investor with a significant opportunity. If the current RBA take a similar view to that taken in September 2008, we may be closer than we think to a cut in the official cash rate and a return to investor confidence.



- Rising Interest Rates (1 O'clock) - In May 2022 we experienced the first of eleven interest rate rises. Rates have increased from 0.10% and are currently sitting at 3.85%. We are now likely heading towards target cash rates of between 4.00% and 4.50%.
- Falling Share Prices (2 O'clock) - For the 6 months to September 2022 the S&P/ASX Accumulation Index fell 11.8%. For the six months to 31 May 2023 the S&P/ASX Accumulation Index is down 0.8%.
- Falling Commodity Prices (3 O'clock) - Despite being remarkably strong, Iron Ore, Oil, Met Coal, Thermal Coal and Copper prices have all fallen from their peak.
- Falling Overseas Reserves (4 O'clock) - According to the International Monetary Fund, total Global currency reserves dropped to \$11.6 trillion at the end of September, falling below \$12 trillion for the first time since March 2020.
- Tighter Money (5 O'clock) - Consumers and businesses are facing increased borrowing costs, making it more difficult to access debt to acquire assets.
- Falling Real Estate Values (6 O'clock) - The Domain House Price Report to 30 March 2023 has shown annual median house price declines for capital cities declining by 5.1%, including a 9.9% decline for Hobart, 8.4% for Sydney and Canberra, 6.2% for Melbourne, and 4.9% for Brisbane.

Despite where we might be precisely on the Investment Clock, Contact believes that the current market is offering a great opportunity for the long-term investor. BKI's investment strategy is one that invests for the long term in profitable, high-income producing, well managed companies. Many companies within the BKI portfolio are offering:

- Fully franked dividends that are growing and offer an attractive yield,
- Growth prospects and a reasonable Return on Equity with which to reinvest,
- Sound Balance Sheets,
- Good Management Teams,
- Attractive Valuation Metrics.

In addition to watching the Investment Clock we've been keeping an eye on the greatest bond bull market of all time. If you look at the chart on the right, you will see the 10-year bond yield has broken out of its 40 plus year down trend and is thus likely to move in to a long-term, long-cycle up trend. Turning points are often indicated by a war, which we have between Russia and the Ukraine, and an accompanying monetary explosion, which we have globally. The previous low was immediate post WW II.

Recently, COVID has supplied the extra monetary boost, and we have seen extreme energy prices and accompanying infrastructure boosts from many countries globally.

Although the current business cycle appears complex, as it did through 2008, there are certainly look-a-likes between the two periods. This has been accelerated this time by central banks around the world boosting the cycle with COVID cash handouts, necessary as it was, but not curtailed quickly enough. We are now also seeing in Australia a very uncertain mortgage cliff expected to hit in the coming months.

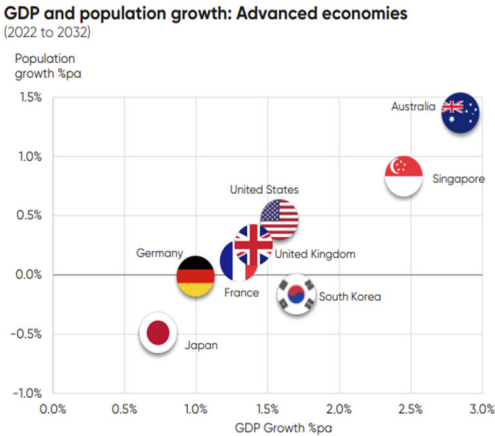


The mortgage cliff adds further interest to this cycle. Falling Real Estate Values on the Investment Clock is obviously directly related to interest rates, and rates are the indicator of Tightening Money and toughening credit - which drives the cycle. Thus, the Investment Clock diagram focuses on property top of cycle and bottom of cycle, and the reason we may see rates eased before most are expecting it, just as we saw back in 2008.

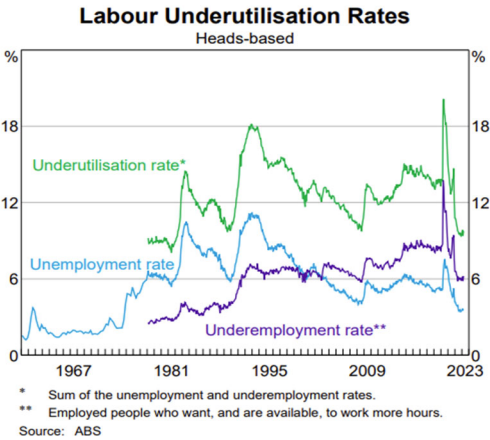
Taking Advantage of Opposing Forces

Relative to global peers, Contact believes that the Australian market continues to look attractive. Even with rising inflation and interest rates and with the backdrop of a slowing global economy, it is highly likely that Australian equities can keep delivering earnings growth throughout FY2023 and FY2024. The Australian market could continue to provide an opposing force.

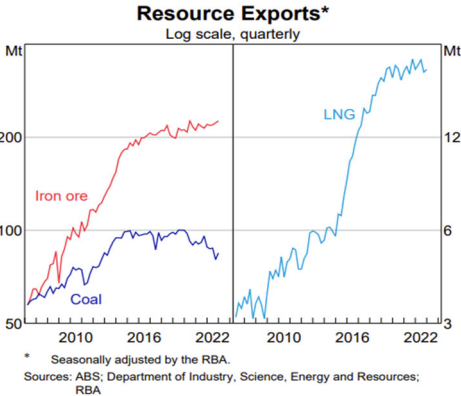
Australia well placed vs global peers



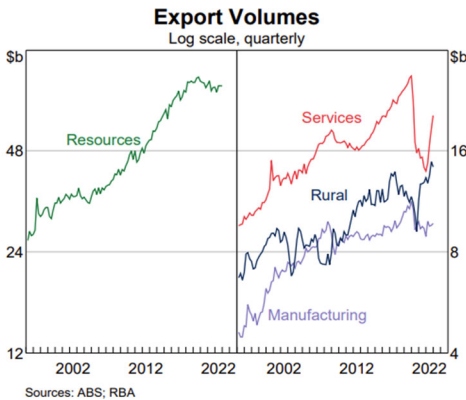
Historically low unemployment rate



Significant commodity and energy exposure

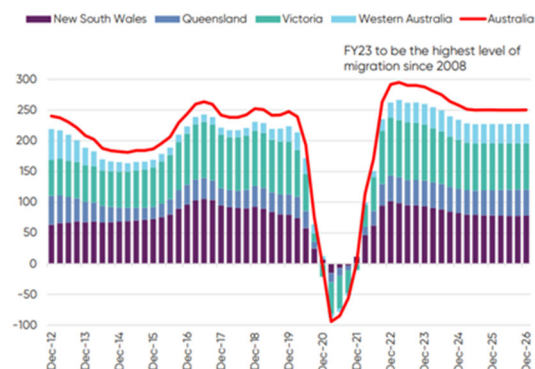


A prime Agriculture sector

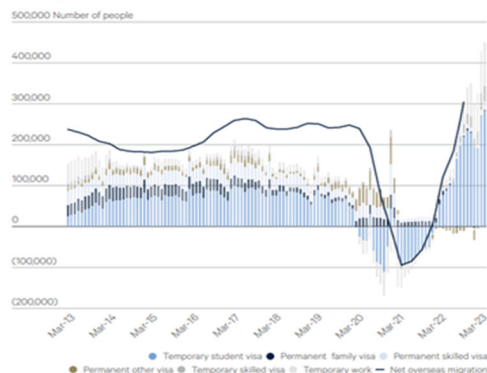


Attractive and safe tourism and education destination

Net overseas migration by state
(12 months rolling, '000 p.a.)



Australia – Net Visa Arrivals vs Net Overseas Migration
Rolling annual



Conclusion

The interesting take away from looking at the RBA Media Releases from 2008 is the number of similarities. Again, Australia is well placed versus global peers. It's interesting to note that once the RBA started cutting rates in 2008, the S&P/ASX300 Accumulation Index gained 22.0% over the next year.

What goes around comes around. Contact continues to stay positive on markets, and through the management of BKI, focuses on investing for the long term in profitable, high yielding, well managed companies.

Stock selection is bottom up, focusing on the merits of individual companies rather than market and economic trends. BKI is focused on investing in quality companies for the long term that have a history of and are expected to continue to pay attractive and growing dividends.

The BKI portfolio is very well positioned for the period ahead. As at 31 May 2023, the PE Multiple for the BKI Portfolio was 13.3X compared to the PE Multiple of the ASX 300 Index of 15.1X. While the Dividend Yield for the BKI Portfolio was 5.2% compared to the Dividend Yield of the ASX 300 Index of 4.0%.

Fundamentals	S&P/ASX300 Index	BKI Investment Company	Relative
P/E Multiple	15.1x	13.3x	-1.8x
EV/EBITDA Multiple	8.2x	6.9x	-1.3x
Price to Book Value	2.0x	2.2x	0.2x
Dividend Yield	4.0%	5.2%	1.2%
Net Debt / EBITDA	1.2x	1.0x	-0.2x
EPS Growth	3.7%	3.0%	-0.7%
Return on Equity	16.2%	18.1%	1.9%

Source: RBA; ABS Chart Pack – May 2023; Factset, IRESS, Dexus, Mirvac, Medibank Private, Oxford Economics, Domain.

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