Quarterly review

March 2017

Market environment

The first quarter of 2017 was noteworthy for the fact that it was the least volatile for markets in recent memory, as measured by Wall Street's CBOE Volatility Index, known as the 'fear gauge', which recorded its 2nd lowest reading on record. This stood in stark contrast to the tumultuous last six months of 2016, dominated by Brexit and Trump.

This period also coincided with better economic conditions, as evidenced to date by improvements in 'soft' data (i.e. sentiment type indicators such as business and consumer confidence) rather than 'hard' data (i.e. measures of actual activity such as GDP growth). Soft data often leads hard data pointing to stronger economic growth ahead, with signs being seen globally, not just regionally.

With global activity picking up, focus remained on interest rates, with the US Federal Reserve, the global benchsetter, following up its December rate rise, with another in March as well as flagging the possibility of another two (2) in 2017. The 'normalisation' of interest rates has begun but remains 'hard' data dependent, as the recovery in the world economy is still a balancing act – productivity growth in the Western world remains weak, wages growth is still universally low and investment does not yet mirror increasing business confidence. Political instability also continues to lurk in the shadows.

Generally, markets de-rate in the face of interest rate rises but not always. It needs to be accompanied by improved corporate earnings to not do so. Thus far, the expectations are positive, hence the rise of 5.5% in the US-based S&P 500 index in the last quarter. The recently commenced US quarterly reporting season, we trust, will validate this optimism. That said, some of this rise has been attributed to the promise of Trump tax cuts etc. which now seem longer-dated, following his failure at the first hurdle to repeal Obamacare. Others argue the upswing was entrenched before this anyway. And whether the upswing is cyclical or a structural change also remains a matter of debate for another day.

As to Australia, we are somewhat different, with the economy and national discussion dominated by housing presently and ways to quell its influence. Whilst the housing boom saved us from the mining downturn, what will replace it? It is questionable whether non-mining investment can do so, with the rise in energy costs not helping and the consumer already doing their fair share, dipping into household savings. That said, local interest rate rises seem unlikely, and the December half earnings reporting season overall showed improving company profits with it being solid but far from spectacular.

The Australian share market, measured by the All Ordinaries index, underperformed the US, returning 3.2% for the quarter, lead by the Healthcare, Consumer Staples and Utilities' sectors. We own stocks in each of those sectors; with the notable performer CSL. Despite strong interim results from resource companies, share prices at best consolidated past gains. Earnings trends continued to support companies with international exposure. Cost-out gains are now being harvested rather than identified.

The trend of the big cap sector outperforming the small cap sector endured, with our portfolio, allowing for this, performing more or less in line for the quarter. Half year results for our companies were reassuring, supporting our investment cases, albeit we did end the quarter holding a reasonably high level of cash. The overall market result did also hide a certain skewness, with performance fairly narrowly focussed and many a company treated harshly when a result did not come up to expectations.

Our Quote for the Quarter

"Easter is the only time it's OK to put all your eggs in one basket."

Anon.

Portfolio activity

In the last quarter, we added two (2) stocks:-

- **ANZ Bank** (one of the well-known Big 4 Banks, as a result of a reduction in the headwinds for banks in general, with 1) loan growth, albeit housing biased, remaining strong; 2) interest rates beginning to rise, and also with the imprimatur of regulators in order to slow growth; 3) their markets' trading income being boosted by the 'Trump effect'; 4) loan losses still low; and 5) global delays in imposing further capital requirements. There is a sweet spot at present supported by a reasonable valuation and a more than sustainable dividend).
- **Vocus Communications** (diversified telecommunications provider servicing the consumer, small business, enterprise, government and wholesale markets in Australia and New Zealand, backed by an extensive network infrastructure. Following its price halving but a better than anticipated interim result, in which it reaffirmed its FY17 profit guidance, along with showing meaningful improvement in operational metrics, we are attracted by its industry positioning (one of 5 major players) and the opportunity to reduce costs stemming from recent acquisitions).

In addition, we also added further to our holding in **Westpac** (for not dissimilar reasons to ANZ), increasing our overall exposure to Banks in a favourable environment for them.

During the quarter, we removed two (2) stocks:

- **Telstra** (after a disappointing result, where past momentum in its mobile division, its primary growth driver, came to a halt, with significant investment required to develop income streams at the same time increasing question marks arise with regard to sustainability of its dividend); and
- **Japara Healthcare** (following a deterioration in operational performance, evidenced by weaker occupancy, and at a time when the sector is subject to increasing scrutiny and likely additional regulation, with various reviews in progress, motivated by a need to reduce the taxpayer subsidy of the the industry in one form (care fees) and in another (the bond guarantee system)).

We also reduced our positions, from a profit-taking/risk mitigation perspective, in **Challenger** and **CSL**.

Commentary

The Trump 'reflation' trade, premised on tax cuts, infrastructure spending and less 'red tape', which was seized upon by markets, has fizzled of late, with legislative roadblocks arising and attention turning to geopolitical risks (e.g. North Korea). The market is down from its early March peak as a consequence.

That said, and as alluded to earlier, the economic upswing (and market), it is argued was never just about Trump. There is a long propagated school of thought that recoveries from financial crashes, like the GFC, take time with the average recovery period eight (8) years and with the best antidote being to clean up balance sheets quickly, keep monetary policy loose and provide fiscal stimulus where prudently necessary. The recovery witnessed is seen to validate that but been lost in the 'Trump effect'.

The by-product of this is that the recovery is likely on a stronger footing, with the global macro outlook clearly improving and with interest rates to move higher over time. Against this backdrop, there is cause for cautious optimism, as, despite the headwind of interest rate rises, such rises seem likely to be slow and over a long timeframe. An economy gradually recovering remains our position than one about to accelerate significantly from here

Market valuations, unadjusted, are fairly full at present and require 'hard' data demonstrating growth picking up and in turn evidence of improved company earnings to provide a further leg up. I say unadjusted, as allowing for current low bond yields, higher equity valuations can be justified for now.

In navigating this, whilst still focussed on companies and their individual investment merits, we are happy to be selective and hold cash in lieu until an opportunity arises but aware of the cycle and the impact it may have on performance and valuations in general. Our recent addition to Banks, beneficiaries of the current economic environment, is reflective of this.

This could be best summarised as 'winning by not losing'.

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