Quarterly review

June 2017

Market environment

The 2nd quarter of 2017 and end of FY17 concluded with share markets in general steeling themselves for the end to easy monetary policy, heralding the eventual paring back of the GFC-initiated stimulus.

At its June meeting, the US Federal Reserve continued its 'normalisation' of the Federal Funds Rate, increasing it 0.25%, equating to the 3rd increase since last December. Statements from the European Central Bank (Mario Draghi), Bank of England (Mark Carney) and Bank of Canada (Stephen Poloz) implying a similar bias, saw global bond yields push higher. Rising bond yields mean increased interest costs and act like gravity on the value of assets i.e. assets are worth less when interest rates rise. This reversal will be a historic challenge for all concerned.

However, such moves are only being instigated/discussed as global data has improved; an unequivocal positive and reflected particularly in the ongoing improvement in the US economy. This is no better demonstrated than the tightening in the labour market in the US, culminating in unemployment being at a 16-year low. Europe itself is also experiencing a recovery recording its 16th straight quarter of growth.

At the same time, inflation worldwide remains subdued, with improved labour outcomes not lifting labour costs i.e. wages. This breakdown in the 'Phillips Curve' i.e. decreased unemployment traditionally leading to an increase in inflation is perplexing many a policymaker. Reasons proffered for this range from the impact of globalisation, technological innovation to lower workforce unionisation. This, plus still stubborn levels of debt, reinforces our view of any interest rate rises being very gradual to say the least.

With growth improving, inflation in check and despite the headwind of rising bond yields, the US S&P 500 (+2.6) and MSCI Europe (+13.1%) indices continued their ascent in the last quarter. Interestingly, political events took a back seat, with tensions over North Korea, the outcome of the French presidential elections and Trump impeachment rumours somewhat ignored.

As to Australia, we appear to be 'out of sync' with world growth. Sustained by a mining boom initially, then a housing boom, we are seeking the next gear. The government recognised this in the May Budget with its infrastructure announcements, mindful that the Reserve Bank of Australia cannot lean on the interest lever any further. The last few cuts have only fuelled an already stretched housing market.

The local economy does still continue to grow but at a relatively subdued pace, with real wage growth i.e. after inflation, non-existent at present. Also, despite this environment, we are not immune to global events with bond yields here rising and mortgage rates on the increase, as the banks pass on this higher cost of funding as well as implement the regulator's wish to reduce lending in certain parts of the market e.g. to investors. Our economic indicators are more flatlining than showing signs of significant improvement.

The Australian share market, measured by the All Ordinaries index, returned -2.4% for the quarter, lead down by Financials principally, following the announcement of a bank levy as part of the May Budget, as well as Energy, as doubts arose about the extension of OPEC's supply cuts. We are underweight both sectors and combined with certain positive performers e.g. Amcor overall outperformed, albeit finishing slightly negative for the quarter. For the 1st time in a while, the small cap sector returned to some favour outperforming the large cap sector.

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Portfolio activity

In the last quarter, we did not add any new stocks but did add notably to positions in the following:

- **Link Group** (the largest provider of fund administration services to Australia's superannuation fund industry and a leading provider of shareholder management analytics and share registry services) acquired a similarly large UK operation, Capita Asset Services, as its entrée into that market, raising capital via a rights issue to fund the purchase; the entitlement to which we took up; and
- **TPG Telecom** (the no. 2 Australian telecommunications provider servicing the consumer, small business, enterprise and government markets, backed by an extensive network infrastructure) is now embarking on an expansion into the mobile phone arena both domestically and in Singapore for which capital was raised via a rights issue; the entitlement to which we took up.

During the quarter we removed three (3) stocks:

- **Vocus Group** (following issues coming to light, post our initial investment, with regard to their accounting and cash flow, amongst other things, with the decision justified by a substantial downward revision to earnings guidance shortly post our exit);
- **Billabong** (at a loss, with strategy changing from our initial premise for investment, which was for a focus on core brands and cost reductions from consolidating activities. The prevailing retail environment here and overseas also didn't help despite expectations to the contrary, with price falling further since); and
- **Aveo Group** (at a small loss, following concerns with regards to reputational risk and the quality of their service leading to the real possibility of greater government oversight in the retirement village sector in general, again with a further price fall post sale).

We also reduced our positions (for a 2nd time this FY), from a profit-taking/risk mitigation perspective, in **Challenger** and **CSL**.

Commentary

As we enter FY18, the prognosis for the world economy is reasonably positive, with the International Monetary Fund (IMF) recently reaffirming its expectation for global growth of 3.5% this year and in the process upgrading its forecasts for Europe, Japan, and China. The US was downgraded but owing to delays in legislation relating to tax cuts and spending than any rising risks.

Nevertheless, the question still remains 'will inflation ever pick up with growth?' Whilst monetary policy makers continue to plan so, the last decade has been one of shrinking price growth and maybe it is more a dream than an expectation. If anything, a case can still be made that prices may still be heading down.

The consequence of central bankers' concern with inflation is that they will seemingly at best only 'tap on the brakes', thus enabling any recovery to continue and providing a relatively investor friendly scenario of benign conditions and reasonable growth.

With the prevailing environment constructive, but mindful of the domestic economy, we continue to be predisposed to companies with opportunities beyond Australia and accompanying exposure to offshore earnings. We still see the AUD as more likely longer term to depreciate than appreciate.

Our attention will shortly turn to earnings reporting season (August/September) to provide evidence of the strength of corporate earnings and answer specific questions such as whether fears about Amazon's arrival on our shores is impacting retailers or whether interest rate rises are starting to bite in terms of household spending and construction. Most market activity of late has been premised on anecdotal information than hard numbers with this the first opportunity for a closer examination.

We approach this though optimistically, given the lacklustre share market performance of the last 6 months, in which we built up some cash looking now to deploy it in opportunities we have been monitoring, who meet our investment criteria and importantly at a reasonable valuation.

Our Quote for the Quarter

"Nothing in life is to be feared, it is only to be understood. Now is the time to understand more, so that we may fear less."

Marie Curie, physicist and chemist.

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