Market Commentary

April 2018

EXECUTIVE SUMMARY

- ASX 200 had worst Q1 since 2008, declining more than 5%. Interest rate sensitive sectors led the fall (Financial, Reits, Infrastructure), Growth stocks outperformed (Healthcare, Food, Overseas earnings).
- Global economy remains strong, though lead indicators moderating. Bond yields continue to rise, reflecting buoyant activity.
- Earnings growth is offsetting rising internet rates. We worry this won't continue later in 2018 if rates and inflation rates continue to increase.
- Following an exceptional run, Technology now experiencing some headwinds. Exposure is being reduced.
- Prospects in Food & AG remain attractive. Australian companies well placed to capitalise on Asian growth.
- The outlook for commodities looks attractive following several years of cost cutting & supply side constraints, valuations cheap by historical standards.
- Reporting season Positive. The recent correction has seen valuations improve, supported by earnings upgrades. ASX200 less that 15X with ~ 7% EPS growth in both 2018 & 2019

2017 the Easy Year: 2018 Could be More Challenging

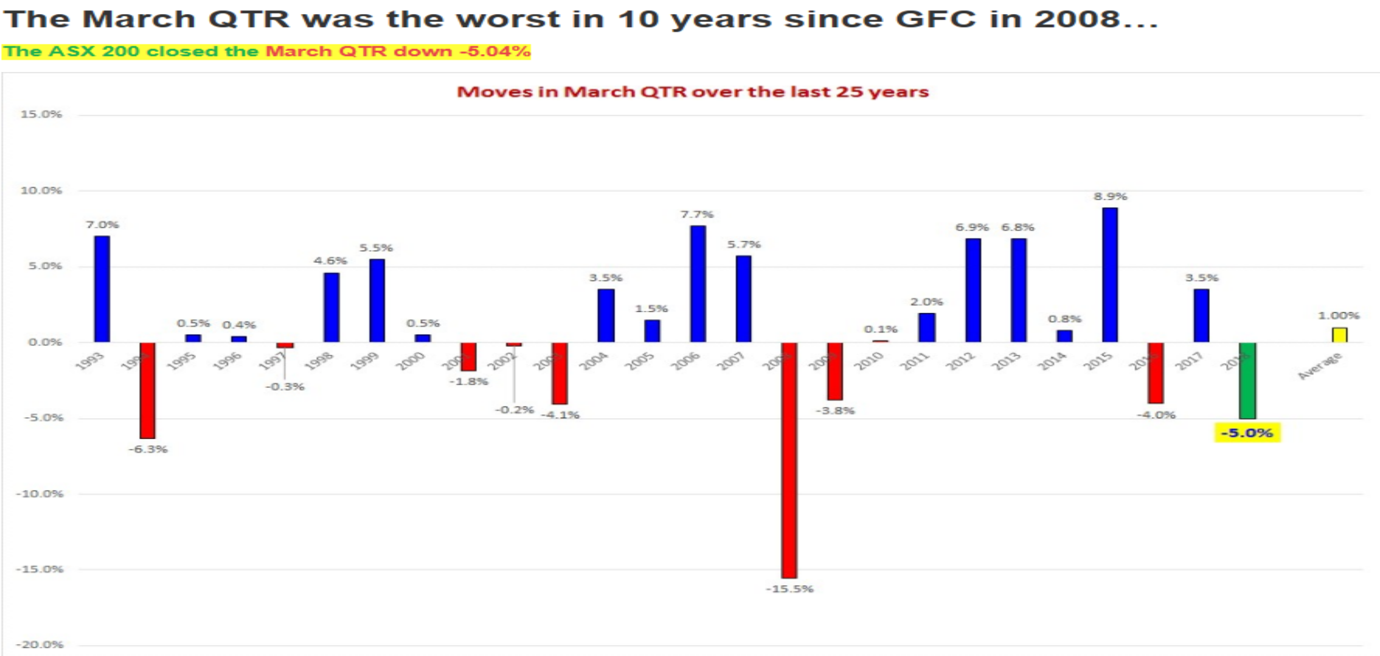
We start with exactly the same introductory headline as in January. The only difference is that we expected the first part of the year to be constructive for equity markets followed by a more challenging H2. Results are now in and Q1 turned out to be the toughest first quarter since 2008. The ASX200 Accumulation index declined 3.8%, in what has historically been one of the strongest quarters of the investment calendar. However with Financials making up 35% of the ASX200, recording a negative 5.9% decline and Materials 18% of the index declining 3.3%, a poor outcome was inevitable.

Following several years of strong performance, Income oriented portfolios have struggled. The combination of rising interest rates (bonds) impacting negatively on Financials, AREITS, Infrastructure, a Bank sector Royal Commission, and a challenged Telstra have been major headwinds. In contrast, Growth portfolios have performed strongly. Healthcare, overseas earners, Asian consumer exposed stocks, Small / Mid cap stocks have performed strongly.

Global Trends Still Supportive, Though Moderating

Through Q1 global macro trends have remained positive. Quantitative easing has remained in the Eurozone and Japan, the US has turned less accommodative. China has continued to see growth at 6.5%pa. Recent signs are that leading indicators have now peaked, suggesting that there will be a slowdown in the latter part of 2018. We emphasize though this will be a moderation from the strongest levels of global growth experienced since the onset of the GFC in 2008!

There has been much focus on rising inflation and the possibility of a sharp rise in bond rates off 35 year lows. Labour markets are tightening globally: unemployment rates are falling, participation rates are increasing and wages are increasing at modest rates in most developed economies. Commodity prices such as oil and industrial metals are also increasing, but at modest rates. H2 could be a different story.



Source Coppo Report

Storm Clouds Building

The one thing financial markets don't like is uncertainty. After several years of low volatility, in 2018 we have seen a sharp rise. Key contributing factors behind this rise include concerns over possible trade wars, the Trump factor, privacy issues associated with the use of data in the Technology sector, rising interest rates and inflation.

So far, the negative impact of higher bond rates globally has been offset by strong growth in corporate earnings. If interest rates continue to rise through 2018 to the point where they negatively impact economic activity and corporate earnings growth then equity markets are vulnerable. Key indicators of future recessions are the shape of the yield curve (difference between short and long term interest rates) and credit spreads (difference between AAA and B rated debt securities).

From an equity investor perspective, recessions have always led to meaningful market corrections.

Evolving Technology Story

The most powerful driver of equity markets in recent history has been the Technology sector. In the US it has been the FAANG stocks-Facebook, Apple, Amazon, Netflix and Google. In Asia it has been the BATS-Baidu, Alibaba, Tencent and Samsung Electronics. This group of stocks now dominate the world top 10 when measured by market capitalisation. Their performance over recent years has been exceptional and benefitted the performance of many portfolios.
Our sense is that some of some of the strong "following breezes" these stocks have enjoyed over the last few years are now experiencing "headwinds". Some of the emerging issues include:

- Political focus on tax (Euro, US, Aust)
- Disruption to traditional business, property, labour (Trump Amazon)
- Privacy of personal data being commercialised for corporate gain (Facebook)
- Strong revenue growth being achieved at declining margins (Tencent)
- Sheer size, scale and power of emerging giants (Amazon owns Washington Post)

Unlike 2000, the current crop of technology companies are typically highly cash generative businesses. Most are extremely profitable, generate strong free cashflow, have large net cash positions and high return on equity. We expect most will continue to do well over the longer term. In the short to medium term however we suspect that the heightened volatility referred to above will be a feature of the Technology sector. Accordingly, we have been reducing our exposure to the sector and locking in some of the gains.

Food & Agriculture Remain Attractive Growth Sector

We recently attended the Australian Food Forum in Sydney and the Macquarie Food & Ag Conference in Melbourne. This has been an important sector for most portfolios over recent years, delivering strong investment returns. The presentations from across the spectrum made us very comfortable that this sector will continue to deliver strong returns over both the short and long term. Key takeaways included:

- Technology is a key feature within the sector. Ag has delivered the highest gains in productivity of any sector in Australia in recent history.
- Consumer preferences continue to evolve. Sugar, processed, fatty foods are out. Natural, fresh, organic, gluten free, specialised (A2, soy) are where growth is strongest
- Australia & New Zealand "clean, green, dependable" presents a very strong brand in rapidly growing Asian markets. Traceability of product source and quality metrics of product becoming increasingly important.
- Water is a critical input. Each calorie of food requires a litre of water. Daily intake of 3500 calories requires 3500 litres of water.
- Asian protein demand impacting food pricing in Australia along with trends in consumption. Beef and lamb prices have doubled over 5 years, chicken has been stable. Consumption patterns reflect pricing trends.
- Australia is a high cost country of doing business in a global context. Products must be branded, priced at a premium, differentiated to ensure profitability.

Key exposures to the sector remain Costa, Bega, A2, Tassal, Treasury Wines and are evaluating Freedom Foods, Nufarm, GrainCorp and Inghams.

Commodities Throwing Up Opportunities

As we become somewhat more selective about future technology returns, one countercyclical opportunity we focussed on last quarter was commodities. Our premise was two fold: one was the dramatic underperformance of commodities v equities over recent history. market volatility.

This quarter we add further perspective to the commodities theme. We see Electric Vehicles as a "game changer". It will be driven by China, the Eurozone and highly populated urban areas of major cities. Key commodities are lithium, cobalt, nickel, copper, graphite and manganese. Our view is that lithium is not in short supply, however, cobalt and graphite are the two commodities somewhat supply constrained. Of the majors, we see upside to both copper and nickel. Stocks providing exposure include BHP, RIO, (copper), Western Areas (nickel), Syrah (graphite), CleanTech, First Cobalt (cobalt).

The second opportunity CSLA brought to our attention an interesting opportunity in uranium and nuclear power. Although somewhat controversial, nuclear power does represent a practical solution to reducing greenhouse gases in major emerging economies such as China and India. Historically low uranium prices are unlikely to continue in a world where supply has been curtailed courtesy of low prices and increasing demand as Japan continues to restart its closed nuclear plants post Fukushima. Meanwhile China and India continue to expand their nuclear capacity. Ultimately uranium prices need to rise. We are evaluating the most appropriate stock to provide exposure to uranium for those portfolios that a uranium investment is appropriate.

Finally an opportunity we see from an investment perspective is Energy. Despite the recovery in energy prices over the last year or so, energy stocks have continued to underperform. (see chart below- Longview chart). Oil prices have more than doubled from their lows in 2016. LNG prices are continuing to recover as China intends to increase its LNG from 5% of current energy consumption today to 10% to improve its air quality. Oil Search is very well positioned to benefit from this outcome via a high quality asset base and current expansion plans.

Investment Strategy

The recent reporting season was on of the most constructive in recent years. Key trends included:

- Companies with overseas earnings providing stronger growth
- Cost pressures increasing: energy, wages, regulation
- Benefits from "cost out" programs diminishing
- Food sector benefitting from growing Asian middle class
- Stress in consumer related sectors
- Substantial free cashflow in major miners
- Banks earnings growth constrained: costs rising, credit growth slowing, funding costs increasing
- Selective strength in resources: energy, nickel, copper, gold, uranium
- Some exceptional results in smaller cap technology stocks

Given some of the concerns raised above, we have generally increased cash levels in most portfolios and reduced our exposure to Technology. The above commentary on the recent reporting season captures most of our key investment themes. Our strategy will continue to be increasing exposure to defensive, sustainable, predictable businesses capable of weathering less favourable conditions than those currently being experienced.

Market valuations have improved through Q1 as prices have fallen & earnings forecasts have been stable to up. Expectations now for ~7% growth in both 2018 & 2019. Resources are forecast to deliver 18% EPS growth in 2018 & 4% in 2019 (UBS est), and priced at 14x earnings. Other sectors delivering strong earnings growth include Healthcare, Utilities, Infrastructure, Food related stocks and several stocks with significant overseas earnings.

Defensive Growth stocks are carrying a significant valuation premium compared to Cyclicals, Resources & Structurally threatened sectors.

We look forward to catching up with you soon to discuss your portfolio and any change of circumstances or issues that we might be able to help you with.

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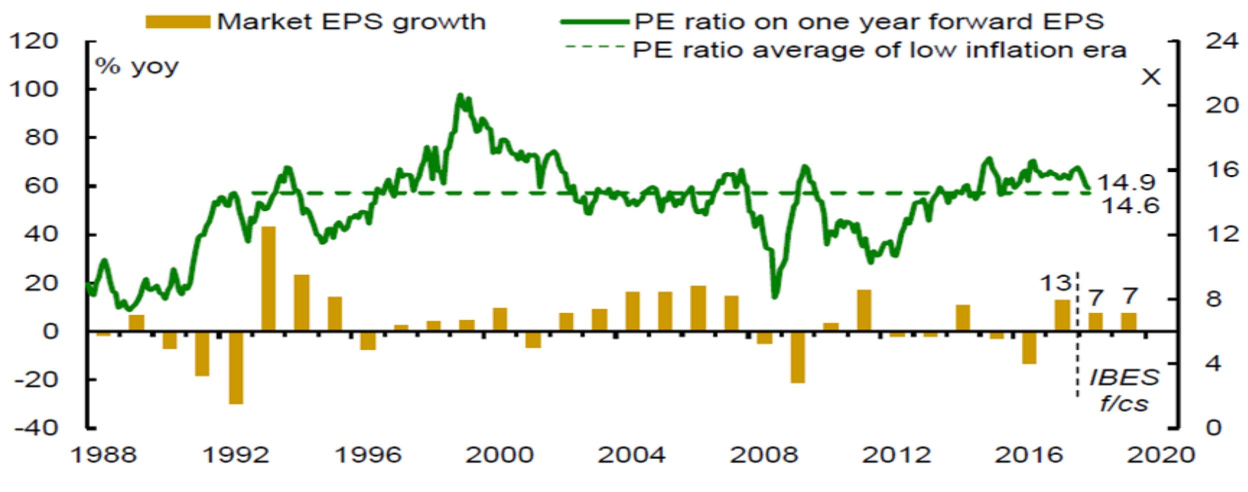
Figure 2. Australian market PE ratio and EPS growth



Source: IBES, S&P, MSCI, Datastream, Citi Research