Monthly Comment – April 2016
Alphinity Wholesale Australian Share Fund

A deflating feeling

Market comment

The market (ASX300 including dividends) put in a decent performance rising a bit more than 3% in April, bringing calendar year-to-date returns fractionally into the positive. It was another month of unusual events which proved quite disconcerting for most fundamental investors. The consensus short in commodities and energy stocks was confounded by movements in the price of their underlying commodities causing something of a scramble in some circles. BHP Billiton, which is exposed to both oil and iron ore, was particularly well-bid and it is unusual to see such a big company go up 22% in just one month. Whether the move is sustained will depend on the price of both commodities and, from our perspective, the present high oil price flies in the face of ample supply and limited demand. But that's a story for another month.

That deflating sensation you can feel is prices in Australia: the Consumer Price Index in the first quarter of the year was negative and the areas of weakness were broad-based. Although calling it "deflation" may be over-stating it a bit: the -0.2% overall number reported would see an item with a $10 price ticket fall to $9.98, so it is very mild. And the annual rate fell to +1.7%, which is just below the bottom of the Reserve Bank's 2-3% preferred range - more about this in BTW. But the trend of weak prices gave some impetus to the Bank's deliberations at its May 3rd meeting which caused it to cut short-term official rates to the lowest point in Australia's history – a mere 1.75% – with hints of more falls to come. While this feels very low by our standards, rates here are still pretty much the highest in the developed world.

What it has done in early May however is remove a bit of support from the $A, which had been stubbornly firm much to the annoyance of exporters.

Commodity prices continued their recent strength as China's economy bounced a little. There is still a degree of skepticism about how sustainable China will be so we're packing our expert off for another research trip this month. But the most important export, iron ore, jumped by more than 20% to end April 54% higher than it was at the end of January.

Global share markets were quite mixed but Australia performed in the top half. Most European markets were up a couple of percent but the US, coming to the pointy end in choosing its putative presidential candidates, was down 1% in $A. The UK market rose 4% but that was mostly currency. Resource-heavy markets like Russia and Brazil did very well indeed, both up around 10% for the month.

Portfolio comment

The Fund lagged the overall market in April, and the big moves were in resources. Resource companies made the best individual contributions, most notably our holdings in Fortescue Metals, Rio Tinto, Syrah Resources and South32, however being underweight BHP Billiton offset much of that. In addition, our holdings in flag-carrier Qantas and property developer Lend Lease also detracted from returns.

Performance*	1 month %	Quarter %	1 year %	3 years % p.a.	5 years % p.a.	Since inception^ % p.a.
Fund return (net)	2.2	3.4	-6.0	4.5	7.1	8.5
S&P/ASX 300 Accumulation Index	3.3	6.4	-4.7	5.0	6.2	7.7

*Returns are calculated after fees have been deducted, assuming reinvestment of distributions. No allowance is made for tax. Past performance is not a reliable indicator of future performance.

^The Fund changed investment manager and investment methodology on 12 July 2010, at which time Alphinity Investment Management commenced managing the Fund and started the transitioning of the portfolios to a structure consistent with Alphinity's investment views. The transition was completed on 31 August 2010. The inception date for the returns for the Fund is 1 September 2010. For performance relating to previous periods, please contact the Fidante Partners Investor Services team on 13 51 53 during Sydney business hours.

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Market outlook

Following its strong performance in April, the Australian equity market has rebounded to levels that it has struggled to move beyond over the last 6-8 months. We expect this will likely be the case again this time. The market is now trading on a PE (Price-to-earnings) multiple which is 5% or so above long term averages. While an improving earnings picture could easily justify this premium, there aren't many areas of the market where earnings look to have the potential to surprise positively.

Higher commodity prices have certainly been supportive of Resource company earnings and there is potential for further meaningful upgrades should prices, especially for iron ore, hold anywhere close to current spot prices. However, the turnaround in economic activity in China and, in turn, commodity prices as well as share prices has been so swift that market participants are likely to pause to gather a better understanding of how much of the uplift has been driven by shorter term factors such as restocking through the supply chain (not to mention outright speculation), and how much is an improvement in underlying demand.

Stephane, our globetrotting Energy and Resources analyst, is in China to try to get a handle on what's going on. As we have discussed previously we see even fewer fundamental reasons for the rally in the oil price, as inventory levels keep hitting new multi-decade highs. Stephane's conclusion from his recent trip to Iran was that the Iranian's post sanction production ramp up would surprise to the upside, has proven spot on so far.

The April bank reporting season gave a mixed report card but earnings expectations for the three major banks that reported have all been reduced. Only one of them, ANZ, decided to cut its dividend as a consequence, but dividend payout ratios remain somewhat elevated for all the banks, and are vulnerable to any further deterioration in credit quality. The "good" news is that the increase in non-performing loans has so far only been experienced in pockets of the economy and in a few high profile company names. The broader economy, and especially small to medium sized businesses, still appear to be performing relatively well and should be further assisted by the RBA's interest rate cut in the first few days of May. This should be supportive for bank earnings and overall corporate earnings, but probably just limits the downside rather than providing too much upside to current market expectations.

Asset allocation	30 April 2016 %	Range %
Securities	98.2	90-100
Cash	1.8	0-10

Portfolio outlook

The volatile market conditions so far in 2016 have been challenging for investors, including ourselves, to navigate. The rally in Energy and Resources has seen a sharp reversal in the performance of "style factors" such as Earnings Momentum (stocks getting earnings upgrades) and Quality (stocks with strong cashflow and return on equity). These factors form an important part of Alphinity's investment process, with an improvement in the performance of the Value component of the process only partly offsetting.

The investment team's experience with Alphinity's process over the last decade and more suggests that underperformance of these factors, particularly the Momentum factors, tend to be relatively short-lived. Whether Momentum will return to the more defensive sectors that, with only brief interruptions including the last three months, have outperformed over the last few years, or if a more sustained change in sector leadership is underway should become clearer over the next few months. Either way, we believe will be able to take advantage of a market environment which we expect will be more balanced, with stocks that exhibit earnings as well as valuation support being sought after.

As discussed in the previous section we see greater potential for the Resources sector to achieve positive earnings revisions in coming months compared to the Energy sector, and we have increased our exposure to the Resources sector to slightly overweight. We see the greatest potential for further upgrades in the iron ore producers Fortescue and Rio Tinto but have also established a position in gold miner Newcrest. We expect a combination of the solid gold price and operational improvements should see this company surprise positively, both in terms of earnings growth and importantly also cash generation, and thus debt reduction.

In the Energy sector, a lot of improvement already appears to be priced in. Market expectations for oil prices in 2017 are still around 20% above current market prices. Market expectations for iron ore, by contrast, are currently almost 50% below the current market price. This leaves a big buffer for any price correction in iron ore once short term factors fade and makes it, in our view, a less risky proposition than oil.

Top 5 active overweight positions as at 30 April 2016	Index weight %	Active weight %
Goodman Group	0.8	2.6
Aristocrat Leisure	0.4	1.9
Sydney Airport	1.1	1.9
Adelaide Brighton	0.2	1.7
Brambles	1.4	1.5

Alphinity INVESTMENT MANAGEMENT

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BTW

Those who remember the high rates of inflation prevailing in Australia during the 1970s and 80s often struggle to understand the notion current in most of the developed world that inflation is too low. Back in the olden day's inflation was a huge concern: it ate away at the value of one's income and savings and produced pressure on wages which then fed back into price rises which then required price rises, perpetuating the cycle. It necessitated high interest rates both to compensate for and to control the inflation. It took a massive effort by monetary authorities, government, business and the unions to finally overcome inflation in the 1990s and it has rarely poked its head outside the 2-3% range mandated by the RBA since.

We certainly don't want deflation though, that can be very bad. In that case the price of assets tends to fall while any debt used to purchase those assets doesn't: a very swift way to wipe out any equity one might have. And falling prices also provide an incentive to delay purchasing goods which is not great for economic activity. Australia's most recent CPI release, for the March quarter, revealed very low inflationary pressures and in fact most measures of inflation were slightly negative for the quarter. Annual inflation has ended up being a fraction below the bottom of the Reserve Bank's target range of 2-3%, which has brought rate-cut speculation back into fashion.

But some people get a bit perplexed with the idea that an inflation rate around zero could be too low: what's wrong with having stable prices? The thing is that a little bit of price inflation is helpful as some costs inflate naturally, especially things like wages and rents. If these are still rising – even modestly – in an environment of falling prices, then profitability can be crunched very quickly. What's so bad about the lack of inflation around the world over much of the past decade that makes policy-makers worldwide appear ever more anxious? This anxiety was first reflected in the various forms of Quantitative Easing (QE) that were implemented in many developed economies since the financial crisis (Australia being a notable exception) and still goes on in many places. More recently it has been demonstrated by the existence of negative interest rates in some parts of the world. And seeing neither QE nor negative rates seem to be working very well, even more radical forms of monetary stimulus are now being discussed.

The idea of negative interest rates takes a bit of time to get your head around and there can be some unexpected consequences. The logical corollary of being charged to deposit funds is being paid to borrow – but surely that couldn't happen, could it?

Maybe it could. We were intrigued by a recent Wall Street Journal article about a chap in Denmark named Hans Peter Christensen (pictured here with his family) who opened his bank statement recently to find that he had actually received interest on his mortgage. Not much, only about $50 worth, but still it was a credit rather than a charge. His mortgage rate had fallen to -0.0562%. Think about that – the more money you borrow, the more money you receive. What could possibly go wrong? Denmark was the first economy to try negative official rates, in December 2011.

Across the bridge in Sweden, our favourite Scandinavian country, ultra-low rates are causing concern at official levels: its central bank is worried that households are borrowing too much, feeding an already extended property market and leaving themselves highly exposed should something happen to cause property prices fall. A law has recently been passed to ensure that Swedish housing loans can no longer have terms of up 150 years as had been happening: from now on loans will be limited to a much more reasonable 105 years. Imagine not just passing your home on to your children, but passing on your debt as well!

With all this concern about low inflation it is worth noting that some countries still have the opposite problem. Bloomberg told us recently that the cost of living in Venezuela rose by 181% in 2015. And this inflation was prior to the government implementing emergency measures to stave off economic collapse, including increasing the price of petrol by 60 times to 6 bolivars per litre – that's still less than A80c – and devaluing its currency by 40%.

It's fair to say that like most things, inflation is best had in moderation. We just hope that the world's central banks are skilful, agile and courageous enough to engender just enough inflation and not too much.

Fund details	
Manager inception date	1 September 2010
Fund inception date	31 October 1994
Fund size	$131.8M
APIR code	PAM0001AU

Fees	
2014/15 ICR	0.90%
Management fee	0.90% p.a. of the net asset value of the Fund
Performance fee	Nil
Buy/sell spread	+0.20%/-0.20%

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Traveller's Tale

Johan went to Hong Kong last month to attend a global investment conference which covered many different companies and investment topics. After having listened to a number of Chinese officials, he concluded that the Chinese Government is still focused on reforming significant parts of the State-Owned Enterprise sector in order to reduce overcapacity and rectify poor capital allocation. However, having seen the impact of a fairly uncomfortable slowdown in economic growth in the past couple of years, the Government has at least for now gone back to traditional stimulus measures to give the raw material-intense housing and infrastructure sectors a boost. Credit growth in China is yet again expanding at what looks like an unsustainable pace, but that is something that the Government will most likely not deal with for at least another year.

Much like the rest of the world, China in its own way has "election cycles" to worry about and it appears as if economic growth will keep being supported by shorter-term measures - at least until the Premier has been re-elected (by the party, rather than the people) for another five-year term towards the end of 2017.

One of the more interesting presentations was on the subject of electric and driverless cars. Today it's not only Tesla but also IT companies like Google and others who are looking to challenge traditional auto makers as cars become more computer-like. Some observers believe that these revolutionary technologies are only a few years away from becoming reality. Walking around in Hong Kong for example the Tesla Model S is already commonplace. It was the biggest selling sedan in Hong Kong last year, helped by generous tax breaks that allow it cost about 40% less than the much less powerful E-class Mercedes. And the government has helped even further by installing more than 1200 charging points.

Johan was bemused but also somewhat concerned after having listened to some very senior representatives of the US Republican and Democratic parties discussing the upcoming nominations of their respective presidential candidates. It was very clear that until now neither party had given much thought to how the election campaign would develop should Donald Trump be nominated as the Republican party's candidate. It seems that even though scenario planning is a key management tool, this is one scenario that was too unlikely and/or unpalatable for either party to even contemplate.

Alphinity Investment Management

Level 12, 179 Elizabeth Street
Sydney NSW 2000
T 02 9994 7200
F 02 9994 6692
W www.alphinity.com.au