Alphinity
INVESTMENT MANAGEMENT

Monthly Comment – November 2016
Alphinity Wholesale Australian Share Fund

Reality Bites

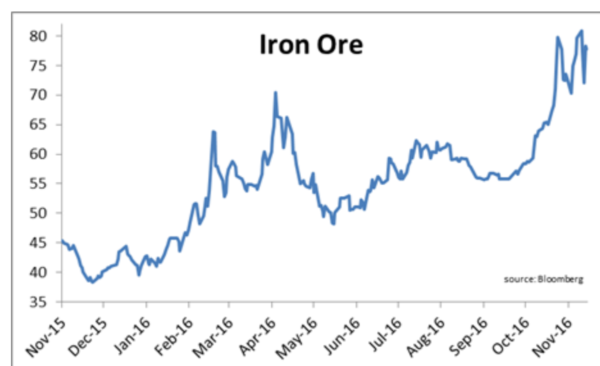
Market comment

The imminent ascension of The Donald to a position that has become known as Leader of the Free World is probably a game-changing event. Another Clinton White House would probably have been a continuation of many of the policies of the past eight years and this is what had overwhelmingly been priced into global markets; Trump's victory, along with equally unexpected Republican control of the House and Senate, means a step-change is now quite likely. This was quickly reflected in equity and bond markets around the world, although not in the way that most expected (see BTW). The $US jumped as an official rate-hike in December appears almost inevitable.

Australian shares (ASX300 including dividends) did quite well in November, up almost 3% for the month despite some pre-election jitters. The election result however set the market alight, with strong performance coming from Financials, Energy and Resource companies. Conversely, rising bond yields put a lid on sectors with high dividend yields, such as Telecoms and Property stocks. Stocks in the Healthcare sector continued their recent run of poor performance, not helped by some aged-care stocks imploding somewhat. November saw the end of the Annual General Meeting season: a narky mood amongst investors was reflected in an unusually high "strike" rate, i.e. shareholders voting against companies' remuneration reports.

It turned out to be a decent month for equity markets in much of the world, seemingly unworried by any real or imagined trade issues that might be approaching. The US came out best in $A terms, up almost 7% to new all-time highs as the expectation of that country being made great again was priced into stocks. Chinese markets were up between 2% (HK) and 6% (Shanghai). Most resource markets prospered, including Russia (+8%), Canada (+5%) and Australia (+3%) although Brazil actually fell 8%. Trump's archenemy, Mexico, was the worst market at -10% , about half of which was due to a sharp depreciation in the Peso. European markets were generally a little lower, -1% in Germany to -5% in Spain. The UK was +3%.

The $US prices of some commodities boomed, including Copper (+20%), Lead (+15%), Zinc (+10%) and Nickel (+7%). Iron ore was up 12% in the month, continuing its run of strength (see chart) reaching as high as $US80/tonne during the month, and closing just below that level; a year ago it was in the low $US40s.



The prices of both Metallurgical and Thermal Coal remain at elevated levels although a supply response in China may moderate that somewhat going into the new year. Oil (Tapis crude) rose 2%, benefiting from the announcement of production cuts by the Organisation of the Petroleum Exporting Countries (OPEC) oil cartel, conditional on cuts by non-OPEC producers. Gold was an exception to the strong commodity trend, its price falling by 8% in November.

Portfolio comment

The Fund outperformed the market in November although most individual stock contributions were quite small. The only real stand-out was metal recycler Sims Metal Management, although investment bank Macquarie Group and iron ore producer Fortescue Metals also helped. Only our position in Goodman Group detracted noticeably from returns as it sold off with the rest of the property sector.

Performance*	1 month %	Quarter %	1 year %	3 years % p.a.	5 years % p.a.	Since inception^ % p.a.
Fund return (net)	3.2	1.6	7.3	4.6	11.5	8.9
S&P/ASX 300 Accumulation Index	2.8	1.1	10.1	5.3	10.4	8.1

*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

Too far too fast? Global equity markets have so far chosen to focus on the potentially pro-economic growth policies of the US president elect, Donald Trump. His more controversial statements regarding things like global trade and immigration have to this point been interpreted as predominantly election rhetoric. While the Republicans gaining control of both the House and the Senate may break the legislative deadlock that dominated the Obama years, we suspect that implementing many of Trump's policies, especially the infrastructure program, will be challenging, at least as quickly as the market has so far been willing to believe. As much as stronger economic growth would be welcome news, even if it came with a pick-up in inflation, we view this as an overly optimistic forecast.

To the extent that the most recent rally in equity markets in general and cyclical stocks in particular can be put down to the "Trump effect", we would expect this to be relatively short lived. On the other hand, most of these trends, as we have been writing about for some months now, were firmly in place before the surprise outcome of the US election. And recent economic data has been more or less supportive of a gradual strengthening not only of US economic growth but also global growth.

In summary, we expect that bond proxy stocks will continue to struggle until global bond yields settle, and that Resource stocks will be well supported by continued earnings upgrades. However, it should be noted that many sell-side analysts have now significantly raised their commodity price forecasts, at least for FY17, so the potential for upside earnings surprise from here has clearly reduced. We are mindful of the global "growth scare" that followed the US Federal Reserve's first cash rate hike in December 2015, but in our view it is unlikely that there will be as extreme a reaction to the well-signaled increase this time around. Positive, and hopefully less volatile, equity market returns are thus our projection for 2017.

Portfolio Outlook

We have started to trim our exposure to the Resource sector somewhat following recent strong gains. As discussed above, we believe that some of the market moves following the US election have been based more on hope than on realistic outcomes. More important however is that the gap between analysts' earnings expectations and ours, and also spot prices, has narrowed significantly. We still see some potential for further upgrades but the very large catch-up in earnings revisions have probably already occurred.

During the year that is almost finished we have seen three changes in relative sector performance: (a) the turnaround in Resources from February (which actually began earlier but was interrupted by the January "growth scare"); (b) the rise in bond yields and consequent underperformance of yield proxy stocks from July (which actually began earlier but was interrupted by the Brexit referendum in June); and (c) in the last couple of months, the derating of expensive structural growth stocks.

We suspect all three of these related themes still have some time to run and may well mature in the same order as they developed. In our view it is too early to start rebalancing the portfolio in the opposite direction, but opportunities are likely to emerge in 2017.

Asset allocation	30 November 2016 %	Range %
Securities	98.6	90-100
Cash	1.4	0-10

Top 5 active overweight positions as at 30 November 2016	Index weight %	Active weight %
Goodman Group	0.7	2.1
Rio Tinto	1.7	2.1
Aristocrat Leisure	0.6	1.8
Macquarie Group	1.9	1.8
Treasury Wine Estates	0.5	1.7

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BTW

Despite pundits and polls overwhelmingly expecting a female Democrat as the next President, Americans have ended up with a much-married male septuagenarian billionaire Republican property developer/reality TV star with remarkable hair and a increasingly prominent family. Republican control of both the House of Representatives and the Senate adds to the frisson of excitement about what the next four years might bring.

Despite pundits suggesting that such a result would cause markets to tumble, with the notable exception of Mexico they mostly rallied. The Gold price went down instead of up, as had been the expectation. It was one of those months. It's been one of those years. 2016 has been a year of expecting the politically unexpected. Surely Britain wouldn't voluntarily leave the EU? Malcolm Turnbull surely couldn't almost be voted out? Could Italians possibly vote "No" at the constitutional referendum and risk throwing that country back into political turmoil, potentially culminating in an exit from the EU (which will no doubt be known as Quitaly)? We might be in for another unpredictable year in 2017 with a few major events approaching, most important being elections in France, Germany and the Netherlands, all countries with significant social tensions and nascent right wing parties.

It's times like these you realise how little pundits really know. Even less is known about soon-to-be President Trump's plans for 2017 and beyond but that hasn't stopped a lot of speculation. Comments he made in the lead-up to the election have been parsed ad nauseum but he made so many, quite a few of which were contradictory, that most pundits have been essentially guessing. One commentator said before the election "*the [media] takes him literally, but not seriously; his supporters take him seriously, but not literally*"

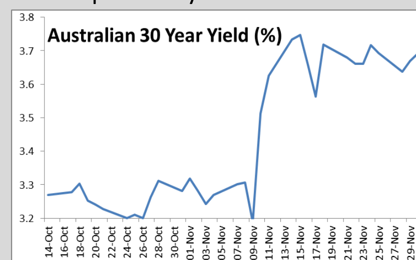
Perhaps we need to turn to the wisdom of the ages to get a sense of what might happen. 2017 will be Year of the Rooster. We consulted a number of Chinese astrology experts (or random websites about such) and came up with the following opinions of what a Rooster year might bring. One said "*the rooster [is] the sign of dawn and awakening, triumph and success can only be achieved at the price of hard work and patience*". Another said Rooster years are dominated by "*the orientation towards progress, honour and maximum integrity, people learning to temper their ardour*". And "*people will be more polite and less stubborn, but they will have the tendency to complicate things*"

So it's looking good for 2017, until you realise that Trump was born in Year of the Dog 1946. Rooster years tend to be only "*average years for the Dog, as some unexpected problems on the health and romantic levels might show up.*" Let's hope he has no such distractions from running the Free World!

But Trump could end up being a game-changer if his fiscal plans can get through what should, in theory, be a friendly Congress. Cutting corporate and personal tax rates and spending a trillion dollars on infrastructure might not be conductive to any hope of a balanced budget but it could stimulate the economy nicely in the short term. It would certainly involve massive issuance of bonds, and bond yields have reacted accordingly.

Bond yields in the US reached their lowest in history in the past few months but rose sharply on Trump's election win. According to Bloomberg, November was the worst month on record for US bonds. There has been a significant flow-on impact on Australian bonds as well as a lot of yield-related assets, including some equities. The US 30 year bond yield has gone from lows of 2.1% to 3% at present, a move that would have caused the value of those bonds to fall sharply. For example, a bond you would have paid $117 for in July would be only worth $97.50 on December 1: not what you want from a supposedly risk-free investment. Losses at the shorter end of the yield curve would obviously have been less, a ten year bond losing 9% and a two year bond only 1%, but after what has been a very long bull market for bonds, it may be that the move upwards in yields has only just begun.

In what might turn out to have been a master-stroke of timing, in October the Australian Government issued its first ever 30 year bond. Up until now the longest bonds issued tended to be for 10 or 15 years, but demand was such (and maybe the need to borrow was so great) that it ended up raising $13 billion at what now looks like a bargain rate (for the borrower) of 3.27%. Treasury won't need to repay the capital until March 2047. That bond ended the month at 3.7% which would have caused holders a rather painful -7% return for November. The big move happened in just a couple of days – this chart shows its daily trading from issue date to the end of November. -7% would be a poor monthly return for a share but not entirely unexpected, but for bonds it is unheard of.



How far will this move in yields go? In the context of history, yields both here and in the US are still extremely low so any hint of inflation making a comeback will tend to shift them higher. Inflation has been absent in most of the western world for the last decade, despite vast amounts of unconventional monetary policy aimed at reigniting it, but once that genie is out of the bottle it can be hard put back. Let's hope the global Central Banking community is up to the task of responding appropriately when the time comes.

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BTW2

Last month India took the radical step of withdrawing from legal tender the two largest-denomination bank notes, 500 and 1000 rupees (~$A10 and $20) in an attempt curtail counterfeiting and terrorism financing, but also to bring that country's large black economy into the open and extract some much-needed tax revenue. The two notes represent more than 85% of the total cash in the economy. There is to be a brief amnesty but anyone left with those notes after the end of the year risks having just a pile of worthless paper. The initial reaction was huge lines of people at banks waiting to deposit cash and a massive surge of deposits – Rs2 trillion (~$A30 billion) just in the first couple of days. It did however provide a new career path for people with a bit of time on their hands as a queue placeholder – pay someone to wait in line for you and call you when they're almost at the front.

India's move is not unprecedented. The EU last year stopped printing its highest denomination note – €500 (~$A700) – for similar reasons. That note was so notorious in terrorism and drug-smuggling circles that it had a nick-name, the Bin Laden. €1 million in €500 notes weighs about two kilograms and would fit in a small satchel; in the next highest (€200) note it would weigh 5 kg and require a briefcase. Unlike India though, Europe is not banning the note, just gradually withdrawing it from circulation when they appear.

The US was way ahead of this trend, ditching notes higher than $US100 (~$A130) back in 1969: before that it also had bills with $500, $1000, $5000 and $10,000 face values. Switzerland has a CHF1000 ($A1300) note but these are very rare. Regular readers will know that we have a soft spot for Sweden: that very forward-thinking country is well on its way to having a completely cashless economy with more than 80% of transactions settled electronically. No less a thought-leader than Björn of ABBA fame has decreed that the ABBA museum will never accept cash! There is still some resistance to going completely cashless however. In a rare example of Swedish humour one banker put it this way to *New Yorker* magazine: "Ask a customer, 'Do you have cash on you?' *'I never have cash on me.'* 'We are thinking of taking away cash.' *'No, you cannot take away cash!'* 'But you don't have any cash.' *'Yes, but if I want to have cash you should have cash.'* 'But you never have cash!'. You get into a kind of Cash 22 situation."

What about Australia? There are presently about 300 million $100 notes circulating in the system, $30 billion worth. The number of $100s on issue increased by 9% in the last year. The $50 polymer note has an average life of 17 years but the Reserve Bank of Australia (RBA) is unable to calculate the same stat for $100s as so few of those notes have ever come back to them worn out!

The most recent RBA Annual Report said that there is $70.2 billion of all value banknotes in circulation. This represents almost $3000 for each man, woman and child in Australia. Really? We're all carrying around/storing that much? Of course businesses also hold cash but even so there is a huge amount sloshing around. We would never insinuate that Australians are up to nefarious activities with it, but we suspect that a lot is stored under the metaphorical mattresses of the elderly to provide for a rainy day – or maybe to conceal a bit of wealth for pension purposes.

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