Monthly Comment – January 2017

Alphinity Wholesale Australian Share Fund

The Hangover

Market comment

January is normally a fairly quiet time in the Australian equity market, the calm before the storm of the February reporting season. This year was different, containing not only a slew of company-issued earnings downgrades (plus the odd upgrade), numerous CEO departures and, in the USA, the inauguration of its new President. There were lots of ups and downs but when all the smoke had cleared the outcome for the ASX300 (including dividends) was a fall of less than a percent for the month. Within that however there was, as always, quite a divergence between sectors. Health Care and Resources were the clear winners appreciating about 5%; the Property and Industrial sectors both declined about 5%.

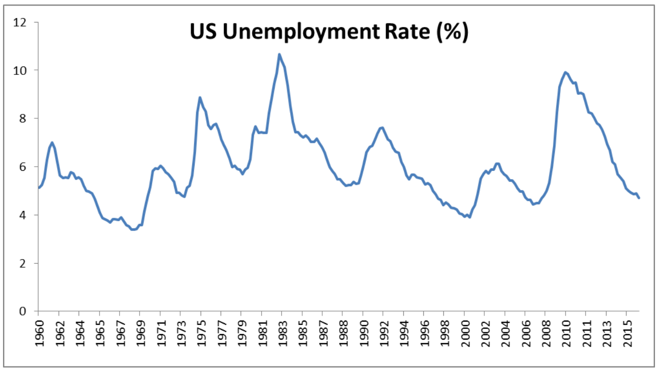
The $A moved higher in January, rising 5% against the $US from US$0.72 to almost $US0.76. The hangover from the Trump equity rally and inauguration was reflected in offshore market returns that, in $A, made our small fall look good. Brazil's resource-heavy index rose 7% but pretty much everywhere else was lower. The UK, US and Japan were all more down than 3%, and most European markets were even worse, especially Greece and Italy (-7%).

While Australia seems to chug along recording steady but unexciting levels of economic growth, other parts of the world look to be picking up somewhat. The USA is most of the way through quite a positive round of earnings reports and unemployment there has reached not just the lowest level in a decade but is approaching cyclical lows (see chart). The UK is doing better than feared and, although the real impact of Brexit won't be known for some time, the UK economy seems to be thriving with its much lower currency. Even Europe, in which until recently only Germany seemed to be prospering, seems to be picking up a little; hopefully politics won't get in the way with elections in the Netherlands and France in the next few months and in Germany later in the year. The stimulus in China seems to be dragging the rest of Asia along with it. In 2017 we have, for the first time in some years, the potential for a period of coordinated global economic growth. This has been an important factor to support commodity prices.

$A resource prices underwent some moderation of 2016's strength in the lead-up to the Chinese New Year. Metallurgical Coal fell almost 30% and Thermal Coal 10% – although both remain much higher than a year ago – but the price of Iron Ore was steady. Most precious metals rose during the month with the exception of Gold, which was unchanged. Base metals were reasonably flat with the exception of Lead (+13%) and Tin (-11%). Oil trended lower as the supply response in the US to higher prices in the wake of the Organisation of Petroleum Exporting Countries cuts last year became evident. Oil drilling rigs in operation there have risen from 316 in mid-2016 to 583 at the end of January. The ability of US oil production to quickly respond in this manner has become a moderating influence on oil prices in recent years, and should keep prices in check for the foreseeable future.

Portfolio comment

The Fund performed a little ahead of the market in January. The best returns came from diversified resource giant Rio Tinto and global wine producer Treasury Wine Estates. On the negative side was global logistics company Brambles which provided a soft operating update during the month.



Performance*	1 month %	Quarter %	1 year %	3 years % p.a.	5 years % p.a.	Since inception^ % p.a.
Fund return (net)	-0.6	6.6	14.3	6.6	11.4	9.2
S&P/ASX 300 Accumulation Index	-0.8	6.4	17.3	7.4	10.4	8.4

*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

From a market perspective at least, 2017 has thankfully started off in a less dramatic fashion than last year. While most economic readings at this time 12 months ago were on an accelerating downtrend, the picture is considerably brighter today. Just as bad news tend to feed on bad news, the same is also true in the reverse. A year ago falling commodity prices raised concerns about not only resource company prospects but also banks' bad debts and the risk of overall deflation. The subsequent rise in commodity prices has not only delivered significantly higher resource company earnings but also reduced risks for the overall economy in Australia and globally.

It is encouraging that historically reliable leading indicators such as company purchasing managers' intentions point to further improvement in industrial production in a range of countries and regions. Even broking analysts' company earnings estimates, which typically start off too optimistically and fade, have been on an upwards trajectory for some months now. Admittedly however, while the geographic breadth of earnings improvement has been encouraging, the range of industry sectors that stand to benefit, other than from the removal of some downside risk scenarios, is more limited. This appears especially true in Australia where earnings upgrades have been more or less contained to the Resources sector and the handful of companies that would benefit from higher bond yields. Add to this the uncertainty resulting from US President Trump's aggressive policy stance since taking office in recent weeks and the picture gets more complicated.

The upcoming February reporting season should shed some light on how the non-Resource part of the market is faring. Based on the unusually high number of pre-announcements in recent weeks, a mixed bag of results looks inevitable. While we continue to see upside to Resource company earnings and share prices, these are typically less driven by results announcements than by commodity prices. Following the impressive 12-month returns we have just experienced, further consolidation for both the broader market and the resources sector should be expected.

Asset allocation	31 January 2017 %	Range %
Securities	98.0	90-100
Cash	2.0	0-10

Top 5 active overweight positions as at 31 January 2017	Index weight %	Active weight %
Rio Tinto	1.9	2.4
Goodman Group	0.7	2.1
Treasury Wine Estates	0.6	2.0
Macquarie Group	1.9	1.9
Aristocrat Leisure	0.6	1.8

Portfolio Outlook

The portfolio continued to benefit from being overweight Resources and underweight yield-proxy stocks in January. We see no reason to change this stance while global growth prospects are firming, as growth should underpin both commodity prices and bond yields. Apart from these sector skews stock selection will, as we wrote about last month, in our view be a more important driver of portfolio returns in 2017. The validity of this statement has perhaps to some extent already been highlighted with a number of high profile market updates already resulting in significant share prices moves. Most of these updates have been due to company-specific factors rather than improving or deteriorating sector fundamentals. Our portfolio has to date had both some wins (Resmed, Bluescope) and losses (Brambles) and the upcoming reporting season will no doubt provide more winners and losers. We believe there are strong prospects for good news in key holdings Macquarie Group, Fletcher Building, AGL and Treasury Wine.

CBA is the only major bank to report its first half result while the others, which have September year ends, will provide an update on their first quarters (October-December 2016). We see the prospects for the sector as fairly evenly balanced. Short term prospects have improved somewhat for a number of reasons: requirements to hold additional capital have been delayed, competition in mortgages is easing and bad debt losses have stabilised, helped by low interest rates and the recovery in commodity prices. On the other hand, profitability (Return on Equity) is likely to be structurally confined over the next few years as credit growth remains relatively low and capital levels relatively high. And that's assuming bad debt losses remain at or below average levels.

Within the sector however we see some interesting dynamics with the structural forces mentioned above disproportionately impacting the retail-focused banks, CBA and Westpac, which also tend to trade at higher multiples. While in the longer term the business mix of NAB and ANZ may have a higher degree of risk due to those banks' greater exposure to losses in business lending, in the current low interest rate and low growth environment bad debts should remain reasonably benign. Instead, we view the efforts of both banks to transfer capital from poorer-returning areas (the UK in NAB's case, Asia for ANZ) to more profitable segments in Australia, such as domestic mortgages, as more important and positive drivers. We believe NAB is more advanced in its re-allocation efforts but feel that both banks should be able to offset the structural pressures on their respective profitability through this mix shift. Of course, for CBA and WBC this means increased competition in their largest and most profitable product segment. The Fund's key bank overweight is NAB, followed by ANZ.

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Traveller's Tale

Bruce managed to briefly escape Sydney's sweltering January heat to visit some rather pleasant farms in the idyllic north of Tasmania, around Devonport, which are operated by company that is small by listed standards but a giant in its field, and which contributed nicely to the Fund's returns last year, Costa Group.

Costa is one of the few Initial Public Offerings from the 2015 vintage that has prospered, and is now trading about 50% above its listing price. It grows and markets a wide range of produce – citrus, tomatoes, mushrooms and so on, but the focus of this trip was its berry operations. Costa grows a large percentage of the blueberries, raspberries, strawberries and more recently blackberries in Australia. This is a growth industry, thanks to berries' "superfood" status. Some are very high in antioxidants, which is apparently a good thing. And they are superfoods that are nice-to-eat too, unlike some others.

Berries aren't that easy to grow in the quantities required to make an industry, and it is here that Costa's scale and access to capital is quite an advantage. It operates in several growing regions around Australia to maximise production and minimise its exposure to adverse natural events. These include the Atherton Tablelands near Cairns, Corindi on the mid-north coast of NSW, Tasmania and Western Australia. (Costa also has farms in China and Morocco). Such a geographic spread means that it can supply most berries pretty much year-round, as opposed to for just a couple of months of the year as most single-region growers do, and command premium prices.

Costa uses protective measures like netting, glasshouses or plastic sheeting (as with the strawberries shown below), which allows fruit to be grown in a relatively controlled environment and produces better quality and higher yield than when unprotected.

You might think that growing berries should be fairly simple but there is a lot of technology that goes into it. The gene strains of the best-tasting and best-lasting berries are patented, and only Costa has access to them in Australia. Strict quarantine combined with the product's fairly short shelf-life means that there is only minimal import penetration.

The growing is not only technical but also very labour-intensive: Costa employs more than 1000 people permanently although this rises to almost 7000 at the peak of picking season. It has become the employer of choice among seasonal workers as it pays them properly and treats them well. For instance, while strawberry pickers in many places spend the day on their hands and knees, Costa has invested considerably in installing "tables" upon which the plants sit, raising their level to waist height and greatly reducing the physical strain on pickers.

Although their berries are not classed as organic, they almost are as there are rarely any chemicals used in the growing process. Instead the inevitable pests (some of which actually assist in pollination) are controlled with natural predators, so the tunnels are abuzz with life even when no people were there. And there can be few pleasures simpler or greater than wandering down vast rows of raspberry bushes and occasionally testing for quality.

Costa's scale has also allowed it to invest in infrastructure which enables it to maximise the value it extracts from its fruit: chilled packing sheds and smooth logistics means the produce makes it to market in better condition than most, and command good prices. Having said that the nature of seasonal produce is to have large rises and falls in price, and the company's strategy has been to increase production massively in recent years to make berries more affordable in order to increase consumption. This seems to be working a treat: the extra volume you can sell for even a modest fall in price is substantial. This early in their growth plans, the prospects for Costa appear to remain positive.

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BTW

The word on everyone's lips these days seems to be "Trump!" Since his ascent to the role of US president he has created a flurry in pretty much aspect of life, not least the markets. While a Clinton victory would have been more or less a continuation of the status quo, Trump's whole *raison detre*, and possibly the reason he prevailed, was to shake things up in Washington.

Since the election (is it only three months ago?) he has certainly been shaking things up, including gently discouraging a number of companies from considering moving jobs into lower-wage countries. He was able to claim victory on several occasions even before his inauguration in January. But he has also been credited with creating a whole new industry: Tweet damage control. Yes, according to online US publication *Quartz*, there is now big business being done by legal and consulting firms in Washington DC for companies impacted, or frightened of being impacted, by a Tweet from The Donald. In fact a number of the firms are setting up formal advisory packages to sell to nervous companies, a bit like Tweet insurance.

"Say what you will about his hands, but Donald Trump now has the most powerful thumbs in the world" *Quartz* said. Trump supporters (and there were 63 million who voted for him) represent a powerful bloc and are capable of making or breaking a company's share price and even its business. Companies as diverse as Boeing, Ford, GM, Toyota, air conditioning maker Carrier and fighter jet producer Lockheed Martin have been targeted by Trump tweets with noticeable (albeit fairly temporary) impacts on their share prices.

And it seems the risks are skewed to the downside: being praised by Trump is almost as bad as being slammed! Not long before his inauguration Trump issued a tweet thanking (unlisted) Maine-based outdoor company LL Bean for its support. The reaction of the 66 million who voted against Trump (and presumably others who didn't vote at all) was massive, with threats of boycotts and vows to throw away the LL Bean products they presently own. A similar thing happened to shoe company New Balance (also unlisted), which largely manufactures in the US. A neo-Nazi website dubbed it the "official shoes of white people" after its CEO supported Trump's trade policy, and threats of a boycott swiftly followed. There's even a page on social media site Reddit which neatly summarises the organisations and people Trump enthusiasts should both support and boycott. Incredibly, the first organisation it lists for support is Wikileaks, which only a few years ago was excoriated by Trump's party for sharing the US's deepest secrets with the world media.

Where will it all end? It's hard to say but one thing is clear, Trump's tweets have become compulsory – not to mention compulsive – reading for those in the market; he now has more than 40 million followers between his two accounts. Thankfully our friends at Bloomberg have released a feature which will automatically add his tweets to your inbox, making it even easier to share in the President's stream of consciousness.

Alphinity Investment Management

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