Monthly Comment – July 2018
Alphinity Concentrated Australian Share Fund

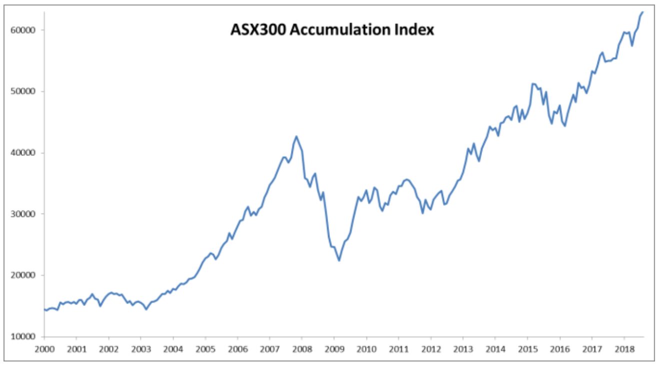
Winter Chills

Market comment

The share market seemed to go into hibernation in July, probably reflecting a mix of the cold weather, school holidays, a lot of big sporting events in the Northern Hemisphere and – with the exception of a few companies who mostly had bad news – a corporate information vacuum ahead of the August full-year reporting season. Australian shares edged up by a little over 1% for the month, leaving the market (ASX300 including dividends) at its all-time high. Most equity markets around the world also showed modest positive returns in $A terms – the best being in Europe, which had generally low- to mid-single digit returns, reversing recent softness. Increasing chatter about tariffs and the consequent increasing trade friction should really have worked against rising equity markets.

Reporting season was well under way in the US and some cracks started appearing in some of the high-performing technology stocks. Apple however became the world's first $US1 trillion ($A1.35) market capitalisation company; for context the market cap of the ASX300 at the end of July wasn't too much more than that, $A1.9 trillion. Apple is a massively profitable company. The market expects it to make more than $US60 billion of post-tax profit in the 2019 financial year so it is still only on about 15x earnings. Outrageous as it seems, a trillion dollars is probably justifiable.

Most of the commodities relevant to Australia were soft during the month: iron ore and thermal coal did OK but coking coal traded off sharply. Base metal prices were down as much as 11% (lead), and energy prices were also down, the different types of oil falling between 5% and 8 %. Notwithstanding those trends, our overall resource exposures did quite well, as noted below.



Local economic news was mildly positive, and justified the Reserve Bank's decision to leave short term rates unchanged yet again: it is not two years since the last change in monetary policy. Inflation remains subdued and fractionally below the Bank's 2-3% preferred band. Retail sales growth was positive but only just; consumer confidence however improved and remains quite positive.

Apparel retailers did well as winter started to bite and consumers' wardrobes obviously proved inadequate. Business confidence too remains mildly positive, as reflected in the continuing increase in full-time employment and a steady unemployment rate. The balance of trade remains in surplus thanks mainly to the resource sector: coal, iron ore and gas.

Portfolio comment

The Fund outperformed nicely in July although there were few stocks to call out: just lots of little winners and no big losers. Qantas and Reliance were the best contributors, but not owning Telstra unusually hurt performance slightly. In aggregate most of the value was added in the Industrials, Materials (ie Resources) and Consumer Staples sectors.

Performance*	1 Month %	Quarter %	1 year %	3 years % p.a.	5 years % p.a.	7 years % p.a.	Since inception^ % p.a.
Fund return (net)	1.9	7.7	20.4	11.5	12.0	12.6	11.8
S&P/ASX 200 Accumulation Index	1.4	5.8	14.6	8.0	9.2	10.0	9.3

*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

While the threat of trade wars and new US sanctions on Iran are some of the news-dominating headlines, July brought welcome relief to global markets as investors focused back on company earnings reports which have generally been solid, especially in the US. The upcoming Australian earnings seasons will see companies reporting predominantly full year results rather than quarterly or half-year results as has been the case overseas. The trend however should be largely the same, at least for those companies exposed to the healthy global expansion that remains intact, although maybe at a slightly lower rate of growth.

Earnings growth in Australia is likely to be led by Energy and Resource companies as a result of good commodity prices, but Information Technology and Healthcare stocks are also poised to deliver strong results. While there can always be some late surprises, and the quality of reported earnings can often give valuable insights into future prospects, most of the market's attention will be on managements' outlook commentary for FY19 and how this outlook looks relative to market expectations.

We continue to see some upside to earnings estimates in the Resource sector but note that spot prices have converged with our own forecasts and consensus for many commodities over the last couple of months. This makes it more difficult for the sector to deliver further earnings upgrades, especially as both labour and input costs are now rising. The Energy sector looks more interesting from this perspective as there is still a healthy gap between current oil prices and market expectations in the short and medium term. The heavyweight Bank sector has much more subdued expectations but even the 4-5% consensus growth the market assumes looks like a challenge to us considering subdued credit growth conditions and increasing funding costs. The Insurance sector has required some patience as higher premium rates have been largely offset by increasing claims costs following some adverse weather events, but the opportunity for margin expansion has continued to strengthen.

Outside of these larger trends however, perhaps with the exception of the small but fast-growing IT sector, earnings growth (or lack thereof) will be driven by company-specific factors, and there are plenty of companies that should continue to have good earnings momentum. All up, the market's expectation of about 5% earnings growth in FY19 looks reasonable to us. With the market trading around longer term average multiples our base case for the year ahead remains total return in the mid to high single-digit percent range.

Asset allocation	31 July 2018 %	Range %
Securities	98.2	85-100
Cash	1.8	0-15

Portfolio Outlook

The Fund has achieved strong absolute returns and solid outperformance of its benchmark in recent months and over the last 12 months. This has largely been the result of good stock selection, with sector allocation a positive but a less meaningful driver. Strong earnings and price momentum in the underlying stocks in the Fund is typically an attractive portfolio feature, as good company news tends to be followed by more good news, and bad news by more bad news. This, which we call serial correlation in earnings changes, is a key attribute of Alphinity's investment process. At the same time, we are cognisant of the fact that for any company to maintain earnings growth for an extended period of time is a challenge, and to also deliver earnings ahead of market expectations is even more difficult. Sometimes the upgrade or downgrade trend ends due to company-specific reasons and sometimes because of deteriorating industry or broader macro factors.

There is currently much debate amongst investors as to how long the present good times can last and what change in market direction and/or market leadership may lie ahead. Globally, as well as in Australia, we have recently seen a cooling in the performance of so-called growth stocks at the same time as some more cyclical stocks have also pared their recent gains. We view both developments as a logical response to, in many cases, rich valuations in the growth space and a moderation in global economic growth as trade uncertainty impacts cyclically leveraged sectors. However, it should be pointed out that the most noteworthy falls, be they Facebook in the US or Ramsay Healthcare here in Australia, have been triggered by negative earnings announcements rather than a more broad-based thematic selloff.

Global economic growth is also, thus far, just moderating rather than deteriorating rapidly. As such at this point we don't see any conclusive evidence of a either a change in market direction or in market leadership. While we have continued to reduce our overweight in the Resource sector as the earnings surprise potential has become smaller, we believe that solid overall earnings momentum should be supportive of our current portfolio positioning. We take further comfort from the fact that our overall portfolio valuation metrics are largely in line with the broader equity market.

Top five active overweight positions as at 31 July 2018	Index weight	Active weight
BHP Billiton	6.6	4.0
Macquarie Group	2.3	3.5
CSL	5.3	3.5
Aristocrat Leisure	1.2	3.4
Woodside Petroleum	2.0	3.1

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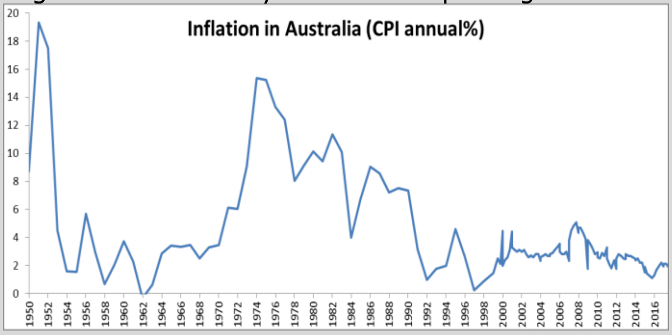
BTW

Much of the western world has been struggling with low inflation for the past decade. This seems a bit odd for anyone who remembers the periods during which inflation was too high and extreme monetary policy measures were required in many parts of the world to bring it under control, including Australia in the 70s and 80s. But it turns out that the only thing worse than inflation is deflation, negative inflation. Why is it so bad if prices go down?



Falling prices might seem great for people who want to buy things, but paradoxically they also act as a bit of a disincentive to buy things. After all, why buy a fridge or lounge or whatever today if it will be cheaper next week or next month? More critically, when asset prices fall a borrower's equity in the asset gets squeezed, as their debt doesn't fall along with it. That doesn't matter too much if the move is small, as has been the case in the Australian housing market so far, but if it were to turn into something like what happened in the US a decade ago it would matter a lot. Imagine a person with a house worth $1m and a loan of $800,000. If the value of the house went down 5% to $950,000 it would be manageable. If it went down say 25%, as some loud voices have been predicting (for years it seems), to $750,000, it would be a problem indeed. You would end up with the lender demanding more equity or possibly forcing the borrower to sell, in which case they would end up owing the difference with nothing to show for it. This is different to the US where in many states a borrower with negative equity could just walk away and leave the bank with the negative equity.

So deflation is not something anyone wants. But neither is rampant inflation. Despite the western world "suffering" from very low inflation, people in the economies with the opposite problem are suffering even more, like Venezuela. Venezuela has a lot of issues, chief among them them being problematic political leadership, but its inflation is also out of control and causing much social angst. The International Monetary Fund warned early this year that inflation there could be as high as 13,000%: that would be like a $1 item rising to $130 over the course of a year. It recently changed its assessment: inflation actually was on track to exceed 1,000,000%. Hyper-inflation like this is not unprecedented. Hungary, at one point just after World War II, had such high inflation that prices were doubling every 15 hours! A similar thing occurred in Germany after World War I, during the Weimar Republic era. Germany today is a model global citizen but in the aftermath of Weimar you couldn't have said that – the seeds of World War II were arguably sown in the depredations its citizens suffered as a result of hyperinflation. Most recently it was Zimbabwe, just in the past decade. It's banknotes reached denominations as high as $Z100 trillion and were still worth nothing; it tired of printing new banknotes almost daily and went to using $US as its official currency.

It's hard to see them emulating Zimbabwe and using the $US: previous President the late Hugo Chavez was virulently anti-American and his successor, Nicolas Maduro, appears no different. As always it is the little people who suffer: the minimum wage is 5 million bolivares a month – scarcely enough to buy a bar of soap. Maduro's solution, at the height of the crypto-craze late last year, was to establish the Petro, a crypto-currency supposedly backed by the country's oil reserves, but went very quiet about it after The Washington Post said it might be the most obviously horrible investment ever: "The petro isn't a crypto, it isn't a currency, and it isn't backed by oil in any meaningful sense. It's just a way for Caracas to try to get around the sanctions against it while raising money from ... people more clueless than itself... There are two things to understand here. The first is that you can only buy petros with dollars, not bolivars. Which, practically speaking, means that Venezuela's people aren't allowed to buy them at all... The second is that you can only use petros to pay your taxes in Venezuela. They aren't good for anything else. And that sets up a very deliberate Catch-22: The only people who can buy petros can't use them, and the only people who can use them can't buy them."

So feel for the ordinary Venezuelans, and hope that our own authorities are skillful enough to generate enough inflation to be helpful, but not so much that it causes issues. But whatever you do, don't buy any Petros!

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BTW2

The energy war has been raging in Australia for more than a decade, with political ideology seeming to outweigh rational and dispassionate thought in some cases. Australia has high per-capita CO_2 emissions, which is a function of our large land-mass, relatively small population and the carbon-intensive nature of many of our industries. The debate has been largely about what should replace the ageing coal-fired power stations which will gradually become defunct over the next decade or so.

It was intensified last year when the French owner of a large generator in Victoria decided, with little advance notice, to close that power station. While a win for the environment, as it used brown coal which is the most polluting fuel in the country, the move also destabilised the national grid as a meaningful proportion of national generation was suddenly no longer available. Doubts around the future of a power station north of Sydney approaching its 50th birthday increased the political panic level further. One thing Australians seem to hate more than carbon emissions is not being able to turn their air conditioning when they want to!

The political debate swung to what should replace this lost capacity: a new coal power station but using better quality coal? Gas, which is still a fossil fuel but produces fewer emissions than coal? More wind and solar? An expansion of the Snowy River Hydro? The debate rages on, generating lots of heat but not much light (so to speak).

The case for more fossil fuel generation however was dealt a blow recently with an announcement by the most fossil-intensive country we could think of, Saudi Arabia. That place which to outsiders seems to consist mainly of liquid dinosaurs and sand has said that, along with Japanese tech company Softbank, it will spend as much as $US200 billion to build a 200 gigawatt solar power plant some time before 2030. Unless there is a major breakthrough in technology, a plant big enough to make that many watts with today's panels would cover an incredible 5000 square kilometres. That would be an area 70km by 70km.

Of course it still has to happen, and over the years we've seen plenty of pipe dreams announced that don't come to anything, but the involvement of the Crown Prince gives it a bit of extra credibility. 200 GW is an enormous amount of electricity, about three times as much as they presently make primarily with the oil they have in abundance. Saudi Arabia admittedly has a fast-growing population but it must also have a lot of other plans for the energy.

Adding to Australia's dilemma is that renewable energy generation at scale now costs less than building new coal power stations, albeit with a lower level of reliability due to the issue of intermittency, periods during which the sun's not shining or the wind's not blowing. But this issue will no doubt be solved with time and technology, and the country's transition away from coal to a mix of lower- and zero-carbon alternatives will take place as a result of the market rather than government diktat. Which is probably a better way for it to happen anyway.

For further information, please contact:

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