alphinity INVESTMENT MANAGEMENT

Monthly Comment – November 2018

Alphinity Concentrated Australian Share Fund

A November to Remember

Market comment

November started out in a promising way, bouncing for a week or so from the very soft October until it was overtaken by more offshore events. The market's 2% fall in November (ASX300 including dividends) marked the third consecutive down month, with the overall market ending 9% below its level of late August. It's not just our market: many global markets have had similar or worse performance. The US S&P500 is off a little less in $A terms, only 6%, but the tech-focused US index, Nasdaq, is 11% lower. In fact, in $A every major bourse other than Switzerland, New Zealand and Brazil is down between 6 and 13% over the past three months.

Macro forces played a big role in producing such moves. One was positive: a suggestion by US Federal Reserve Bank (Fed) President Jerome Powell that the Bank might pause a bit from raising short term interest rates than previously thought caused a frisson of excitement at the end of November; no one is suggesting that a strident Twitter campaign by the US President had anything to do with his change of tone but it surely would not have hurt. This sent the $US down a little and, consequently, the $A rose by 3% to $US0.73.

The rest of the macro developments seemed to be negative. The US/China trade war continued to escalate despite some initially promising signs from the Trump/Xi dinner meeting at the G20 in Argentina. This was quickly undone by the arrest of a prominent Chinese business woman on Iran sanctions charges, which has the potential to get messy should China start doing the same thing to US citizens. There is still a lot to play out here but regardless the Chinese economy is already feeling the negative impact of US tariffs. The EU economy is far from robust and Britain's exit from the EU is becoming messier and messier by the day. It was hard to find much good news for investors other than a small fall in Australian 10 year bond yields to 2.6% and a more material fall in US bond yields to just below 3%.

The price of most commodities fell in November, the worst being Oil which was down 25% in $A terms. Iron Ore came off a sharp 16% on China concerns and both types of coal were lower by a few percent. Precious metals were generally a couple of percent weaker. Base metals were also soft, Copper was an exception: after several months of falls it actually rose 3% in $US and was flat in $A. The Energy sector consequently was the worst performer in November (-11%), followed by the Consumer Discretionary and Materials sectors (-5%). IT was the only sector that went up but it was by less than 1%. The Real Estate and Industrials sectors were both only fractionally lower, also by less than 1%.

As we limp towards the end of 2018 we wait to see if Santa will arrive. The so-called Santa Clause Rally has become a fairly reliable phenomenon in recent years. With so much uncertainty about will he put in an appearance this year? The market is now down 3% for the 11 months to the end of November so we hope for a timely visit to maintain a degree of respectability for the poor old Aussie market.

Portfolio comment

The portfolio underperformed the market in November. Good contributions from positions in ANZ Bank, Qantas and National Australia Bank were swamped by a number of detracting positions, including being underweight Commonwealth Bank. While most were individually quite small, they all added up to a negative month over all. Lendlease announced a large provision for contract losses in its relatively small engineering division which sent its shares lower. Shares in UK bank Clydesdale were hit by fear over the outcome of Brexit; Computershare, which has significant interests in the UK, was similarly impacted. Woodside Petroleum was impacted by the abovementioned oil price, as were those of Santos.

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)	-4.8	-13.2	-0.6	8.7	7.3	11.5	9.6
S&P/ASX 200 Accumulation Index	-2.2	-9.3	-1.0	7.7	5.8	9.4	7.8

* Returns are calculated before fees have been deducted and assume distributions have been reinvested. No allowance is made for tax when calculating these figures.

^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

World equity markets have been under pressure over the last couple of months largely due to global economic growth slowing at the same time that reduced liquidity and higher interest rates, primarily in the US, have put historically-high valuations of growth stocks under pressure. This is an unusual situation, and has been driven by the divergence between the strong economic performance of the US and that of the rest of the world.

The US Fed has played a large part in the tightening of global monetary conditions. Not only has it been raising short term interest rates to the point where US rates are now higher than in Australia, but by ending its net purchasing of Government bonds a few years ago and now shrinking its own balance sheet the Fed has gone from so-called quantitative easing (QE) to quantitative tightening (QT). European and Japanese central banks have not yet made the same U-turn but also have reduced their own bond purchases and signalled their intention to scale these programs back further over the next 12-18 months. The extent to which the end of the world's largest money printing exercise will ultimately impact financial asset prices and economic growth remains to be seen but, if 2018 was any guide the risks from QT remain to the downside.

On a more positive note, it appears that we are close to the end, at least for a while, of the dual pressures of rising long term and short term interest rates with the Fed, after eight rate increases since December 2015, now saying it is close to a neutral setting. The recent fall in the oil price should further assist the Fed in slowing its pace of rate increases in 2019, which should be welcome news for equity markets and economic growth in general. While it would be precipitous to interpret the delay of further US trade tariffs on China as the end of the trade war, the latest news from the G20 summit should also be supportive.

Closer to home economic news also continues to be mixed. Weaker house prices may have some flow on effect on consumer spending and credit growth, however unemployment remains low and ongoing infrastructure spending as well increased resource capital expenditure, even if it's primarily intended to maintain production, should help to offset. A Federal election typically causes a period of consumer and business inactivity but, aside from that, 2019 looks like another year of "muddle through" for the Australian economy. The good news for our equity market continues to be that valuations look undemanding and corporate earnings growth expectations, while possibly still at some risk from the lower oil price and soft residential construction markets, at only a mid-single digit percent growth rate don't appear too elevated.

Portfolio Outlook

Our experience is that by identifying and investing in companies that are able to grow earnings ahead of market expectations we can prosper in varying market environments. The best investment opportunities are often also those that do not rely on any particular macro-economic environment for their success. We continue to search for these opportunities and remain confident in our ability to uncover them.

2018, and particularly the last few months, has been unusual in that most types of companies have been susceptible to the vagaries of global macro factors. "Growth" stocks outperformed strongly for most of the year before suffering a sharp de-rating as interest rates continued to rise. "Yield proxies" somewhat counterintuitively first underperformed but then outperformed as their defensive operational earnings streams were sought despite the higher bond yields. "Cyclical" stocks are of course always the most leveraged to changes in the economic outlook but, at least for Resource companies, investors remain faced with the challenge of working out whether a more subdued growth outlook in China is cause for concern or optimism, as the prospects of renewed Government stimulus increases the worse the Chinese outlook becomes!

With the Fed slowing its tightening program at the short end while continuing with QT, and the trade war not escalating further for at least the next few months, macro factors may now take a step back and allow investors to focus on stock-specific factors again: that would be a welcome development. However, with so many different issues at play and so many different plausible outcomes, we believe a fairly cautious portfolio strategy is still warranted.

Asset allocation	30 November 2018 %	Range %
Securities	98.4	85-100
Cash	1.6	0-15

Top five active overweight positions as at 30 November 2018	Index weight %	Active weight %
Macquarie Group	2.4	4.1
CSL	5.3	3.9
Goodman Group	1.1	3.6
ANZ Banking Group	5.1	3.6
BHP Group	6.5	3.0

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Traveller's Tale

Bruce went to Shanghai in November, ostensibly to attend an investor day held by vitamins company Blackmores but also to see what the other major Australian consumer goods exporters were up to in the Chinese market, particularly in infant formula and wine. His visit coincided with the inaugural Shanghai International Import Expo, an initiative of President Xi aimed at overcoming perceptions that China's trade ambitions were primarily focused on exports, apparently in response to the quite aggressive trade criticisms of the US President.

It wouldn't be a China travel story without some dodgy coffee. There are apparently some decent specialist shops springing up in Shanghai but you need to be in the right part of town to take advantage of them: Starbucks is about as good as it gets in most places. But even Starbucks seems to be going out of their way to make it worse. Being the week after Halloween naturally the Pumpkin Spice Latte was still available, but he also saw a poster promoting a Snowy Cheese Flavoured Latte. Whoever thought that was a good idea?

When departing Shanghai Bruce fulfilled a long-time ambition – to ride a Maglev train. We at Alphinity are big fans of the Sydney airport train which takes us from St James station, across the road from our office, to Sydney airport vastly more quickly and cheaply than a taxi could. Shanghai's Maglev put ours to shame. It is normally quite a tiresome process getting the 50-odd kilometres to the airport from downtown Shanghai: best case in a taxi is about an hour but it can take several times that at peak hour, which is generally when you need to be going there for the 8pm flight back to Oz. Since 2005, however, you have been able to take a high speed train using magnetic levitation.

From Longyang Road Station you can board a spotlessly clean train with plenty of space for your luggage that costs ¥50 (~$A10). Naturally there's a speed readout in the cabin – that's sort of the point of high-speed trains – and the highest speed he saw was a touch over 300 km/h. this took him the rest of the way to Pudong in less than 10 minutes in smooth, quiet comfort. If anything he was a bit disappointed that the trip went so quickly.

TT2

Stephane also went to China in November where he saw infrastructure builders, developers, commodity traders and downstream players, steel mills, miners, think tanks – all people who could provide him with insights into what might happen with the Australian resource sector in the coming year. He travelled a bit more widely than Bruce did, taking in Beijing, Tangshan and Shenzen in addition to Shanghai. But it was while he was in the Beijing airport that he saw a familiar face.

We've all been intrigued by these ads – there are a few as you approach Melbourne airport and they also appear in airports all over the world. All we can say is that he must make extremely good beds if they sell despite the unexcited and, some might say, rather frightening appearance of the proprietor used in the ads. It would make us feel a little nervous, should we fall asleep in one of his beds, that we might never wake up again. Not that we are ever likely to have a chance: a quick perusal of its local website provides no indication of what the beds cost. If you have to ask how much, you obviously can't afford one.

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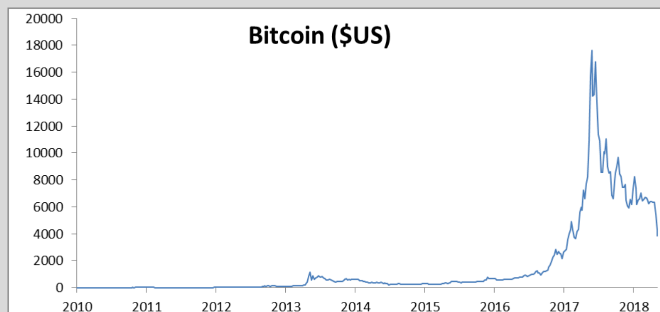
BTW

We haven't done a story on Bitcoin for a while but, after sustaining three months of declining equity markets, we can't help pointing at so-called alternative asset classes like as cryptocurrencies and saying "well, it could have been worse!". Schadenfreude is an ugly emotion, but it can also be quite comforting.

This time last year the hype around Bitcoin was intense: the price of coins was rocketing, funds were being launched here and overseas aimed at providing punters with exposure to Bitcoin and its ilk, and people like us were doing lots of work trying to understand whether there was any substance to the crypto space. We concluded that there was not: while there may be some wider applications of the Blockchain technology which enables the coins, just because Bitcoins are scarce and only growing at a slow rate doesn't mean they are intrinsically valuable.

Bitcoin was launched around the time of the Global Financial Crisis and were initially worth almost nothing. We recounted in December 2017 the story of the first purchase using Bitcoin: two pizzas for 10,000 Bitcoin in 2010, which is about $40 million even at today's depressed Bitcoin price. It went through several iterations of hype in the decade after that. Our friends at Bloomberg started tracking its price in 2010 when it was at the equivalent of US6c. It hit $US1000 a coin briefly in 2013 before slumping, only reaching $US1000 again in early 2017. By Christmas that year – last year – it had reached just short of $US20,000. With the benefit of hindsight this was a massive selling opportunity. Bitcoin had slumped back below $10,000 by February 2018 and proceeded to trend lower, seeming to find a level between $6000 and $7000 for much of the year. Then over a brief period in November it went from $6300 to around $4000 for no apparent reason.

So does Bitcoin look like good buying at $4000? Plenty of commentators in the space say yes, that it is inevitable that cryptocurrencies will take over the world from the old, traditional (and widely accepted) government-backed currencies we all presently use, and that each Bitcoin is worth some very large number, like $250,000 as one booster said earlier in the year. However few of these commentators are completely impartial, and most would have such big Bitcoin holdings that you'd have to take their views with very large chunks of salt indeed. $4000 is obviously a better price to be buying at than $20,000 but we still would not be tempted, after all it could still go down 100% from here. As with anything you are considering putting money into, the principle of caveat emptor applies.



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