Monthly Comment – January 2019
Alphinity Australian Share Fund

Bouncing Back

Market comment

After the fairly unsettling December quarter in equity markets, January's partial recovery came as a welcome relief. The ASX300 (including dividends) rose by about 4% and pretty much all the markets we follow were also up, between 1 and 6%. The US S&P500 rose close to 5% in $A terms after our dollar rallied 3% or US2c. In $US, the broad market indicator S&P500 recovered a decent amount of its recent losses, rising 7%, and the tech-focused Nasdaq was up almost 10%.

These moves happened despite the ongoing instances of national self-harm that is taking place in various parts of the world. The process of Britain leaving the EU just becomes messier and messier and the US Government shutdown, which came about as a result of a disagreement between the President and the newly-Democrat House of Representatives over funding for a wall on the Mexico border, was becoming quite a risk to its own economy until the President called a time-out. Hostilities are due to resume in February but both sides appear intransigent so the chance of a permanent resolution seems low at this point.

The US Federal Reserve Bank (Fed) however helped a lot. It was being widely blamed for much of the weakness in markets thanks to its ongoing program of interest rate increases while, at the same time, shrinking its balance sheet by $US50 billion a month. This brought some enigmatic tweets from the US President to "Stop with the 50 B's". The Fed likes to say that its policy settings are data dependent so, after the data became rapidly softer towards the end of 2018, it hinted that it might pause in its interest rate program in 2019. The market took this to be a good thing.

China's economy also appeared to be sliding as the US trade war started to bite, announcing the lowest outlook for economic growth in some decades. The typical Chinese response to a slowing economy is to provide government stimulus and this was announced in January: hundreds of billions of dollars worth of monetary and fiscal easing. This should be positive for Australia as part will go to infrastructure investment, and that generally boosts demand for raw materials. A growth rate of 6 - 6.5% is a statistic most countries would be thrilled with, although some people are skeptical about Chinese statistics as they tend to come out very close to the Government's forecasts with a degree of accuracy no other country has ever been able to achieve. China's Gross Domestic Product in 2018 would have been about $US13 trillion, still a decent gap to the US's $20 trillion. The US economy is growing at around half China's rate, so if current trends remain it won't take too many years until China becomes number one. Some argue that on a 'Purchasing Power Parity' basis – i.e. adjusting for the fact that prices are so much lower in China than the US – it is already a bigger economy.

Bulk commodity prices rallied sharply in January partly due to the China stimulus mentioned above, but also as a result of tragic events in the other Iron Ore exporting powerhouse, Brazil (see BTW on p3). The price of Iron Ore was up 9% in the month, Metallurgical Coal was up 4% in $US but pretty much unchanged in $A, and Thermal Coal fell 6%.The biggest mover of the base metals was Nickel, up 13%. Energy prices recovered some of the extreme weakness shown towards the end of 2018, with oil rising between 11 and 15% depending on the grade.

Portfolio comment

The Fund performed in line with the market in January as some of its positions bounced back from the fairly dire December market environment. The best returns came from our holdings in gas producer Beach Energy, global logistics property developer and owner Goodman Group, and global engineering company Worleyparsons. These positives were offset by positions in health care company Resmed, which reported disappointing second quarter sales during the month, and airline Qantas after its peer Air New Zealand issued a profit warning.

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)	3.9	-1.2	0.7	9.3	6.8	10.1	8.6
S&P/ASX 300 Accumulation Index	3.9	1.4	1.1	10.0	7.1	9.3	8.0

*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

A change in language used by the Fed signaling a more measured approach to further interest rate increases, as well as its plans to maintain a larger than expected balance sheet (i.e. less quantitative tightening), has boosted equity markets around the globe so far in 2019. Positive statements about the prospects for a US-China trade deal and strong US employment data have also helped. The Fed change, as well as our own Reserve Bank, moving to a more neutral stance is clearly supportive for equity markets. However, it does not change the fact that the global as well as the domestic economy is late cycle. While some of the more dramatic slowdown scenarios have probably been avoided, it is unlikely that we will see much of an acceleration in economic growth in 2019. This is especially the case in Australia where the housing downturn, slow credit growth and lacklustre consumer spending all seem to indicate further downside rather than upside to the economic outlook, and therefore corporate profit growth.

Following the New Year rally, the Australian equity market is now trading not far from long term average valuation multiples, making the upcoming reporting season an important test for the market. Many of the high-multiple growth stocks are again close to and, in some cases above, previous peaks while many defensive stocks have been bid up in the search for earnings certainty and now need to deliver that certainty. In short, while the Fed action has provided important support to global equity markets, with the market having rallied so much, it will be even more important that the earnings are delivered for the rebound to be sustained.

The Resource sector continues to have both valuation support and earnings upside. While economic stimulus initiatives by the Chinese Government have not been of the same scale and are less focused on commodity-consuming sectors than in the past, it nonetheless appears that both infrastructure spending and housing construction there is improving. Another tragic dam collapse in Brazil has further tightened the iron ore market and a fresh round of earnings upgrades for the bulk commodity companies is looking increasingly likely.

Asset allocation	31 Jan 2019 %	Range %
Securities	97.9	90-100
Cash	2.1	0-10

Top five active overweight positions as at 31 Jan 2019	Index weight %	Active weight
Macquarie Group	2.3	2.3
Goodman Group	1.2	2.2
CSL	5.5	2.1
Mirvac Group	0.6	1.3
APA Group	0.7	1.3

Portfolio Outlook

The rebound in January showed the importance of maintaining a diversified portfolio as it was many of the stocks that were harshly dealt with in the December quarter sell-off that rebounded the most. That's not to say all stocks that were susceptible to the slower growth outlook that worried investors last year but got a boost in January should be seen as safe now that the Fed has acknowledged a more uncertain economic outlook. For us, the key remains the earnings prospects of individual companies.

Some stocks that are no longer in the portfolio, such as Sims Metal Management and Bluescope Steel, have genuine earnings risk and don't need further deterioration in economic conditions for that risk to be realised. Current volume and sales trends versus input costs means that earnings downgrades have already started to occur and we expect there is more to come. The share prices of some other cyclical companies however, such as zircon and rutile producer Iluka Resources and oil & gas services company WorleyParsons, were savagely dealt with from a share price perspective but, in our view, have less negative earnings risk – or even have risk skewed to the upside – and should continue to recover as earnings are delivered.

The portfolio continues to be well exposed to the iron ore sector with Fortescue Mining being added to the portfolio in January. Fortescue shares lagged BHP and Rio Tinto and the broader market in 2018 after the discount for Fortescue's lower-grade iron ore blew out when Chinese steel mills prioritised quality. With Chinese steel prices falling somewhat over the last few months the focus of the steel producers has shifted to minimise cost per ton and, as a result, the discount for Fortescue's ore has returned to historical levels. The company's earnings have upside both from higher iron ore prices in general and the reduced discount, in our view.

In a market where we think monetary conditions will potentially be less in focus than last year, individual company specific factors should become more important in driving equity returns. While Fortescue is a cyclical company we think it is a good example of the type of opportunities that should arise in the year ahead. Other opportunities will be in more defensive sectors and, in an economic environment that in general is expected to continue to slow, we will continue to look for companies that fit our investment criteria in this part of the market. However after the strong share price performance of many of these companies over the last few months it is equally important to focus on the earnings outlook of the individual companies. While it's likely that in general they will be resilient, individual company factors will still dominate share price performance.

BTW

In November 2015 near the village of Bento Rodriguez in the iron-rich mountains of Brazilian state Minas Gerais, two dams full of the residue from iron ore mining – effectively contaminated mud – collapsed and the contents of the dam flowed downhill, covering everything in its path. The loss of life was significant, 19 people, and much of the toxic mud entered the nearby Rio Doce and some of it even flowed as far as the Atlantic Ocean, 600km away, as this picture from that time shows. It also caused immense environmental damage and much suffering to down-stream communities which relied on the Doce for water. Minas Gerais means 'general mining' in Portugese which gives some indication of the main focus of the state.

The mine had been in production since the 1970s and operated by Samarco, which was in turn half owned by each of Brazillian mining giant Vale and Anglo-Australian mining giant BHP Billiton (as it was then called). There was significant reputational and financial damage to both companies but, to their credit, they have both gone to grear lengths to mitigate the impact, although of course bringing back the lives and fixing the damage is not possible. The years since have been filled with court cases, inquiries, large fines and rectification work. Former employees want the mine to re-open as there are few other job opportunities in the area, but it is unclear if this will ever happen. A subsequent audit of dams in Minas Gerais found that as many as 20% of them, 1800 dams, were at risk of failure.

In January it happened again and in an even more serious way. A tailings dam located on a mountain at the town of Brumadinho, Minas Gerais, collapsed and sent vast quantities of mud onto the people below causing the loss of many lives – exactly how many has not yet been established but it will likely number in the hundreds – and much environmental damage. The mine's owner, Brazilian giant Vale, ceased operations at a number of mines with similar dams, which further tightens the global iron ore supply/demand balance.

The good news for Australian investors out of the event was that BHP was not involved this time. BHP suffered considerable repuational and financial damage in 2015, from which it is only just recovering, although anything it sustained is insignificant compared to what was suffered by the people in and around Bento Rodriguez at the time. BHP created its own supply challenges after an un-manned runaway ore train was de-railed late last year causing massive damage to one of the main rail lines in the Pilbara (below) and halting ore movements for several months while repairs are carried out. In this case thankfully there were no injuries.

The Brumadinho incident is very bad for Vale, the biggest iron ore miner in the world and even more important to Brazil than BHP is to Australia. It has many similar mines in the area, and many dams situated up mountains. Vale has since exercised a *force majeure* clause that allows it to avoid its contractural obligation to supply ore to customers when events happen that are outside its control. Along with the economic stimulus in China which increases demand, this constriction in supply is sending iron ore prices higher.

Tailings dams are an issue for all companies involved in extractive industries. Australian gold giant Newcrest suffered a tailing dam wall failure last year at its mine near Orange in central-west NSW although this occured between two dams and apparently did not result in any further contamination to the wider environment. Thankfully it was at the bottom of a pit rather than up a mountain so gravity was not a problem. Yet it still halted production at Newcrest's biggest mine for several months and cost an appreciable amount to fix.

Incidents like this remind resource investors of the need to be aware of the many risks involved in mining and to ensure that the management of companies operating in high-impact industries have adequate environmental controls in place, and viable plans to fix problems when they occur.

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Non-Traveller's Tale

Apparently the place not to be in January was Davos, an exclusive ski resort in Switzerland. The World Economic Forum (WEF) meets there each year and discusses issues relating to the future of the world's economies and attendees are generally plutocrats – the elite of the elite, the 0.001% – who network, share views and attempt to come up with solutions to actual and emerging problems. This year it was slightly less elite than usual: the US President didn't make it, nor did the leaders of Russia, China, France or the UK, all of whom were fighting actual or metaphorical fires at home. Sorely missed also was the current Australian Prime Minister who instead wisely chose a family holiday in the beautiful Shoalhaven area on the south coast of NSW.

None of the Alphinity team attended either although a number of Australians did, including some government and opposition politicians and some members of the business and labour communities, but it appears that much of the Forum, other than the schmoozing, could have been achieved by watching webcasts of the sessions which were (and still are) freely available. One panel, The Cost of Inequality, featured young Dutch author Rutger Bregman. He will probably never be invited back to Davos after proposing to increase tax on the rich. A lot. "This is my first time at Davos and I find it quite a bewildering experience to be honest. I mean, 1500 private jets flown in to hear David Attenborough speak about how we're wrecking the planet. I hear people talking the language of participation and justice and equality and transparency. But then almost no one raises the real issue of tax avoidance, and of the rich just not paying their fair share. It feels like I'm at a firefighters conference and no-one's allowed to speak about water. Something needs to change here. Ten years ago the WEF asked the question what must industry do to prevent a broad social backlash. The answer is very simple: just stop talking about philanthropy and start talking about taxes. Taxes, taxes." Bregman spoke wistfully of tax rates in the USA during 1950s when high income earners (those earning more than $US200,000 – roughly $US2 million in today's dollars), were taxed at a marginal rate of 92%, asserting that inequality was a lot lower back then.

Jean-Baptiste Colbert, French finance minister under King Louis XIV in the 1600s, famously once said "the art of taxation consists in so plucking the goose as to obtain the largest possible amount of feathers with the smallest possible amount of hissing". The pure maths is that there are many more not-rich people than there are rich people, so the minimum hissing might come from the rich, although they can tend to hiss quite loudly. It has already started in Australia with policies proposed by the government-in-waiting around (effectively) increasing capital gains tax and reducing the benefits of franking credits and negative gearing – all things the rich presently enjoy, along with many who wouldn't consider themselves rich. Actually defining 'rich' however is problematic: it seems to be generally understood as "someone who is earning more than me".

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