May 2018 — Over the Horizon Market Commentary by David Offer

May was a marginally positive month for the Australian share market. The All Ordinaries Index gained 52 points to close at 6,123. Over May, there was broad sector rotation within our share market. Bank shares continued to slide under the weight of the Royal Commission, while resource and energy shares continued to appreciate on the back of strengthening commodity prices and improving outlook.

Last month I attended a Morningstar Research conference in Sydney. The two keynote speakers were Michael Hasenstab, chief investment officer for Templeton Global Macro and Kerr Neilson, founder of Platinum Asset Management. Both presented their strongest investment theme for the year ahead.

Michael's theme was that US interest rates would rise strongly due to the following;

- Inflationary pressures stemming from the US economy functioning at full employment. The US has only twice in the last 50 years had unemployment as low as the current unemployment rate of 3.8%. Once in the late 1960s and the other for just one month in 2000. Neither subsequent period was great for the US economy, with an extended inflationary period in the 1960s and the bursting of the tech bubble in the early 2000s. Strong employment numbers drove last night's US Federal Reserve 0.25% increase in Central Bank rate to 2%, with a further two rate rises still expected by the Fed in the second half of the calendar year.
- Global financial markets becoming overwhelmed by a huge increase in supply of US debt in the year ahead. Firstly, from new US bond supply as the US continues to borrow heavily. Secondly, as the Federal Reserve starts to sell US debt held on it's balance sheet. On the latter, post the GFC the Federal Reserve purchased vast quantities of US debt to promote growth by keeping interest rates low. In doing so, the Fed pumped up the value of assets held on its balance sheet to an unheard of amount of $4.5 trillion. Known as quantitative easing, this was new territory for the Federal Reserve. As such, so will be the unwinding process. Michael's concern is that there will simply not be sufficient buyers in the market for the trillions in US debt that will soon become available.
- As US debt levels rocket, markets will assign a rising risk premium for holding US debt.

We share Michael's view and believe rising US rates will flow to higher interest rates globally. High interest rates devalue assets that provide a regular fixed income. We are managing this risk with zero exposure to any long dated fixed rate bonds or debt instruments. We are also underweight in listed interest rate sensitive investments such as listed property trusts and infrastructure entities. If interest rates rise strongly, the relative attractiveness of these investments as a source of income will diminish and consequently there is the risk of substantial price falls.

We are also mindful that rising interest rates could derail more indebted nations. As an example, global financial markets are increasing focusing on Italy's debt serviceability. As the third largest European economy behind Germany and France, any default by Italy would have massive implications for the European Union and European economy as a whole.

Kerr Neilson presented an optimistic case for holding resource shares. He believes that the world is entering a new and sustained resources cycle with Kerr's optimism based on the following;

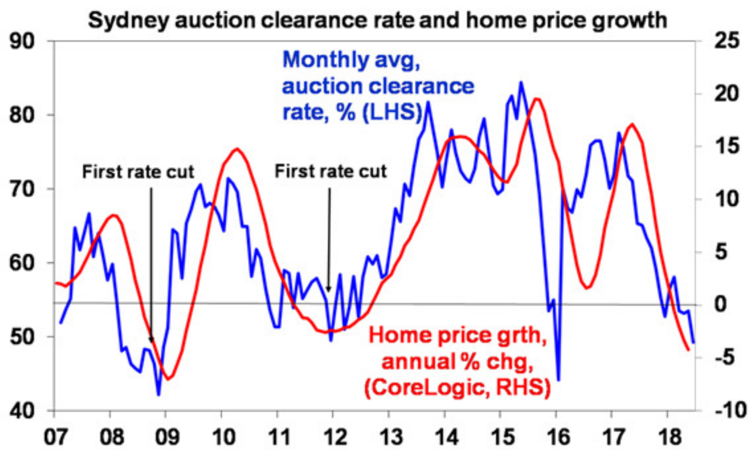
- On balance, world economic growth is reasonable, particularly in emerging economies including populated nations such as India and Indonesia. For such nations, increases in GPD on a per person basis will have a significant impact on global consumption of raw materials and energy.
- Legislation by China and Europe requiring electric cars to become the norm by 2030 will drive massive demand in new metals like lithium and cobalt. It will also drive demand in established metals like copper. For example, while an internal combustion engine uses an average of 23 kilos of copper, hybrid electric vehicles use nearly double that amount at 40 kilos of copper, and a plug-in hybrid electric vehicle uses 60 approximately kilos. Increased baseload power will be required to run this new and rapidly growing fleet of electric vehicles.

- Due to depressed metal prices, there has been chronic underinvestment by resource companies in recent years to maintain and expand resource reserves. Should demand rise as expected, resource companies will not be in a position to easily increase production and this will likely result in steep price rises.

With strong price rises across most resource shares, our decision to both preserve and build on resource positions during the depths of the resources market plunge in early 2016 has been vindicated. Many mining shares have run hard including BHP, RIO Tinto and Alumina from their lows of two years ago. In saying that, now that resource shares have rallied strongly, we are not averse to taking part profits on a number of resource shares to move back to a more market level weighting. We are mindful that the major miners are highly iron ore focused and this is more a China specific story. We have recently highlighted Metals X as an emerging copper and tin company and hope to identify other emerging resource shares into the future.

As I listened to both presenters, the feeling I gained was that the positive economic momentum experienced by Melbourne and Sydney in recent years while Perth suffered may soon start to reverse. I have been observing a quiet optimism in Perth that mining is on a sustained recovery and that the benefits of this will soon start to flow through to the broader West Australian economy.

In Sydney and Melbourne, the buoyant property market that has unwritten much of the broader economic activity is now showing clear signs of slowing. From such elevated property prices, it is possible that going forward Sydney and Melbourne will replicate the current WA residential property market experience. That is, with property prices off a solid 20% since peaking in 2006, it may ultimately take the best part of 20 years to recover back to former highs. (In saying that, I'm allowing 8 years for the WA market to appreciate approximately 25% from current levels. To suggest to anyone in Melbourne or Sydney who is 30 years old that they might have to wait until they are 50 before they see any capital growth in the value of their home is simply a concept they cannot grasp.



With June 30 fast approaching, we are ensuring superannuation funds are in order in terms of contributions received and pension payments made. In July I will be on holiday leave from 3rd July to Tuesday 24th July to recharge after what has been another hectic year. If there are any matters you wish to discuss regarding June 30 or your portfolio in general, please do not hesitate to contact me over the next fortnight. Over the period of July, other staff members should be able to assist with any queries you may have and I look forward to being back on deck firing on all cylinders at the end of the month.

If you would like to discuss any aspect of your portfolio, please do not hesitate to contact our office.

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