May 2017 — Over the Horizon Market Commentary by David Offer

The mantra 'sell in May and go away' held true last month with the All Ordinaries Index declining from near year highs of 5,947 points at the start of the month to close at the end of May down 186 points or 3.1% at 5,761 points. To date, June has staged a partial recovery, up 86 points or 1.5% at the time of writing.

Most of the weakness experienced in May was in our major banks as the share market digested the longer term implications of the new financial levy tax announced in the Federal Budget. Initially this tax is expected to be worn primarily by borrowers and is not likely to be overly material for shareholders. However, there is a broader fear in the market that this levy may continue to be hiked in future years as our Nation's finances continue to deteriorate, as has been the experience in other countries.

We continue to remain surprised that, with so many red flags for investment markets globally, markets remain so stable at this time. One to add to the mix is the shock election result in the United Kingdom (UK), which was called to strengthen the ruling Conservative Government in the lead up to the UK exiting the European Union. This backfired badly with the ruling Conservative party now clinging to power and only through forming an alliance with Northern Ireland's little known and small Democratic Unionist Party. This suggests a particularly rocky road ahead as the UK endeavours to agree on and then negotiate a beneficial Brexit?

In the US, the majority of share market gains this year have come from the strong share price performance of technology shares. This is reflected by the Nasdaq index once again above 6,000 points (6,220 points at the time of writing), a level not reached since the Dot Com boom. This time round there is much more substance with the Index dominated by global technology giants such as Apple, Alphabet, Microsoft, Amazon and Facebook. However, over the last 12 months, these companies have on average appreciated more than 40%. This has been largely driven by the weight of new money focused on index investing rather than underlying profit growth. With valuations now appearing stretched, a correction in these shares would not surprise. We would view any such correction as a buying opportunity as the long term prospects for these companies appear sound.

Due to a lack of suitable investment alternatives, an investment area we have historically stayed away from has been the gold sector. However, it may be time to review this sector with fresh eyes. Gold tends to perform well during periods of global instability and so can act as an insurance policy within investment portfolios. In addition, the world's largest gold producing companies appear likely to experience falling production levels and consume more than 50% of their current reserves over the upcoming decade. As a result, unlike a number of other commodities, it appears unlikely that gold will be oversupplied in the decade ahead and so has a more favourable outlook.

Within Australia, there are a number of emerging mid-tier producers that are using their strong balance sheets to undergo rapid mining expansions as they take advantage of favourable economic conditions with drilling, mining equipment and labour in abundant supply. Two that we favour are Saracen Minerals and Dacian Gold.

Saracen Minerals ($1.15) mine expansions are expected to result in production peaking at over 300,000 ounces in 2019. This should correspond with a significant increase in profit from 2019 with as much free cash forecast to be generated from operations as the Company's current market capitalisation over the upcoming 4 years. There is a high likelihood that further drilling success will continue to extend the duration of mining the Company's primary operations at Carosue Dam and Thunderbox providing significant additional potential upside.

Dacian Gold ($1.92) is presently expanding operations at it's Mt Morgans mine site. Like Saracen, Dacian has a very strong outlook in terms of generating free cash flow from expanding mining operations. Should expansions proceed as planned, Dacian will be trading on a prospective 2019 Price Earnings ratio of less than 4 times and if so would warrant a materially higher share price.

If you would like more information on these companies or have any broader queries with respect to your investment portfolio, please do not hesitate to contact our office.

Yours sincerely,

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