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Clime Australian Income Quarterly Investment Report June 2019

Market Commentary

We approach the middle of calendar 2019 with an uneasy sense of the dichotomy between strong bond and strong share markets, and yet deep uncertainty in the economic and geopolitical environments. An example of strong markets: the broad US equity index, the S&P 500, was up 18% during the six months to the end of June, its biggest first half gain since 1997. The problem is that while stocks are marching higher, corporate profits are not. Investors need to make important long-term decisions in the face of complex macroeconomic and market conditions, but are compelled to do so with unprecedented challenges confronting us.

These include a staggering US$12 trillion in global government bonds yielding negative interest rates, the absence of inflation in almost all developed countries, a US economic growth cycle of almost unparalleled longevity, questions about whether the US and China can negotiate a trade deal in a political mood resembling the Cold War, and uncertainty about what a disorderly Brexit could mean for the UK and Europe.

To be more comprehensive, investors should also be pondering massive government and consumer debt in many parts of the world, the monopolistic challenges of Big Tech, "fake news" and the loss of privacy, and long term risks such as climate change, the inter-generational divide, and the unsettling rise of autocratic populism. But let's not tackle too many issues: we restrict our comments in this report to a brief review of the markets, the economic milieu in the larger countries and regions, and our expectations for the period ahead.

From an historic standpoint, central banks have usually been responsible for an upswing coming to an end, raising rates to prevent an outburst of inflation which then triggers slowdown or even recession. However, in the current situation, central banks have played the opposite role: ensuring the long and slow recovery from the GFC is sustained by suppressing rates to unprecedented low levels. They have been free to do this because of the unusual absence of inflation, despite strong labour markets and low unemployment. The rate of inflation in industrial countries is unusually low; in fact too low for most central bankers, who fear deflation. Central banks are thus under no pressure at all to tighten monetary policy.

The central bankers are sending reassuring signals that, in the case of weak economic prospects or tensions in the financial system, they are ready and able to act. Thus we find neither the US Federal Reserve, the European Central Bank, the Bank of England, the Bank of Japan or the RBA is likely to raise their key rates any time soon. While the yields on government bonds are artificially depressed, with many trading at negative yields, they are likely to rise only slowly if the central banks can manage that transition.

Against this backdrop there is apparently little need for the capital markets to be concerned about how long the recovery will last, for the central banks have signalled their readiness to provide support. But this support helps only to a limited degree: economic fundamentals and market valuations do matter. Recent economic indicators have been mixed and, thanks to the central banks, financial markets are fairly upbeat. With respect to the equity markets, we remain cautious and alert to the many risks, but do not foresee any near term crisis.

Australia

The Australian share market recorded a stellar performance over the first half, with the ASX 200 returning almost 20%. Over the same period, the Liberal-National Coalition was returned to power, commodity prices were strong with iron ore a feature, government bond yields were lower, and the official interest rate was cut by 0.5% at the time of writing. Over recent months, there has been heightened volatility in offshore markets as the China-US trade war escalated and the AUD generally has traded weaker.

A feature has been the extraordinary return from Australian bonds, which have generated significant returns over 12 months and with ten-year yields rallying from 3% to 1.4% (an all-time low yield). It is worth noting that for a similar reduction in yield to be replicated over the next 12 months would require ten-year yields to approach zero. That would require the introduction of a sustained Quantitative Easing ("QE") policy by the RBA, a policy which it says is "unlikely".

Another standout has been Australian listed property securities (A-REITs) where market prices moved from slight discounts to NTA to a significant premium. The rally in property security prices pre-empted the RBA cash rate cut and reflected a general decline in bank term deposit rates. The performance is very much generated by the chase for yield and particularly by retail investors and savers.

Over the year to the March quarter, the Australian economy grew at a below-trend 1.8%. Consumption growth has been subdued, weighed down by low income growth and declining housing prices. Increased investment in infrastructure is providing an offset and a pick-up in activity in the resources sector is expected. The central scenario for the Australian economy remains reasonable, with the main domestic uncertainty being the outlook for consumption. We expect the RBA to maintain its rate-cutting program in support of the economy.

USA

In recent months, the trade dispute with China has become one of the most important macroeconomic issues affecting markets. The direct economic impact of measures that have already been implemented (tariffs raised to 25% on Chinese goods in the value of USD200bn) should be limited. However, further escalations could have a significant negative impact on the US and Chinese economies. This is particularly true if companies abandon their investment plans.

Concerns over escalations in the trade dispute have given fresh impetus to rate cut expectations. The latest statements by Federal Open Markets Committee (FOMC) members suggest that tariffs that have been imposed have had little impact on economic growth so far. However, the Fed seems willing to consider taking more steps as insurance should tariffs be raised further. This means that if a 25% tariff were levied on all Chinese goods, a lowering of key rates would be likely.

The US economy has been pulling away from its western counterparts after a decade of recovering from the global financial crisis. US consumption is strong, consumer sentiment is close to a 50 year high, unemployment is at a 50 year low, and the share market is at an historic peak. And yet, despite solid economic growth, there is little underlying inflation. One explanation is that the US consumer has been a beneficiary of the slumping price of oil. More important, however, is the lack of wage growth – which also has political implications.

Voters will not argue with a strengthening economy, and it does not seem too unlikely that

Market Commentary

President Trump will win a second term in office. His tax cuts have been good for corporates and the wealthier part of the economy and, on the whole, the economy seems to be functioning better than many people expected.

Yet US market valuations are stretched. While stocks continue to rise, corporate profits are relatively stagnant. The ten year average S&P 500 Price Earnings (next 12 months) ratio is 14.8 times; at present, it is close to 17 times. Expectations for S&P 500 third quarter earnings are steadily declining – at present they are actually negative. The strong rally over the last six months has been built upon low rates rather than robust earnings.

China

In recent weeks the conflict between China and the USA has escalated after first the USA and then China imposed new tariffs. US sanctions against the Chinese telecommunications group Huawei have raised serious doubts in China over US readiness to negotiate. The G20 meeting at the end of June appeared to raise the promise of a thaw in the relationship, but there remains a real danger of continued confrontation and the extension of US tariffs to all goods imported from China.

Meanwhile, the latest Chinese economic data have proved weak. The measures implemented so far by the government have not yet stabilised the economy. Earlier this year, the government set a growth target range of "6.0% to 6.5%", down from the target of "about 6.5%" for last year. We expect the government to step up infrastructure investment and create fresh incentives for consumption in a bid to keep the growth rate steady.

Eurozone

Sentiment indicators have so far painted a mixed picture for the Eurozone economy. Germany in particular is showing signs of weakness due to problems with global trade, whereas France appears to have recovered after the turmoil caused in late 2018 by the yellow-vest protests. Manufacturing conditions look particularly weak: the manufacturing Purchasing Managers' Index (PMI) is below 50 (implying contraction), and weaker still in Germany, where the PMI is at 45 and trending lower.

The Eurozone unemployment rate was 7.5% in May, the lowest level since August 2008, and down 0.8% on a year ago. However, there are substantial differences between the major Euro countries. Germany leads the field with an unemployment rate of 3.2%, whereas Spain still has an unemployment rate of 13.8% and both France and Italy have rates above the average at 8.7% and 10.2% respectively.

For the second time in the last three months, the European Central bank (ECB) has adjusted its forward guidance and now suggests that it will not raise key rates at least until the middle of 2020. The forward guidance is for annual real GDP to increase by just 1.2% in 2019, 1.4% in 2020, and 1.4% in 2021. The ECB sees risks relating to these forecasts as "tilted to the downside". Moreover, it underscores its readiness to react to unwelcome economic developments by easing monetary policy again.

Conclusion

Central banks around the globe have turned decidedly "dovish" – and this includes the RBA. While the global economy is hardly firing, it is steady and still in recovery mode, albeit at a slow pace. On the other hand, global bond markets and share markets are priced somewhat expensively, despite the uncertainties being faced. For now, we will retain our relatively cautious outlook – particularly following the heady advances of the last six months which we think are unlikely to be repeated.

Over the next few months, portfolios should be set to generate sustainable yield, above inflation, with an eye for capital maintenance. A balanced approach with good diversity across asset classes is essential. In this low rate environment, investors should expect lower returns.

We have little doubt that at some future point we will endure challenging times. These challenges also bring opportunity. As we have stated previously, it will be the focus on the fundamental process, the diligence to complete the necessary research, and the patience to hold the spotlight on the long term that will build value over time.

Thank you for your continued support of Clime.

Adrian Ezquerro
Head of Investments

Investment Objective

The Fund's income objective is to provide regular meaningful income above the RBA cash rate in the form of quarterly cash distributions. It seeks to deliver a strong risk-adjusted total return and is expected to have a level of volatility of returns significantly less than traditional equity indices. The Fund's risk objective as defined by the annualised standard deviation is 4.0% ± 1.0% over a rolling 12 months with the relative risk to the ASX200 index of less than 40%. In order to maximize the chance of achieving these objectives, the recommended investing time frame is 3 to 5 years.

Investment Strategy

The Clime Australian Income Fund seeks to provide an income stream above the RBA cash rate from a portfolio of Australian listed and over the counter (OTC) securities, with a view to price stability. The portfolio will invest in selected high quality individual securities which in aggregate create a 'best ideas' portfolio for income generation. Portfolio yield is likely to be incrementally enhanced via franking credits.

Performance and Volatility of Return (30/06/2019)

	Portfolio Return**	Income	Capital Growth	Franking
1 month	1.0%	2.3%	-1.2%	-
3 months	2.6%	2.3%	0.3%	-
6 months	6.8%	3.0%	3.6%	-
1 year	7.4%	4.6%	2.6%	0.2%
2 years*	5.8%	4.1%	1.7%	0.2%
3 years*	6.9%	4.1%	2.7%	0.3%
Since Inception	7.1%	3.9%	3.0%	0.2%

Note: Compound (geometric) returns are used in the above table's segmentation of Income and Capital Growth. This may result in small differences when compared with a simple addition of Income and Capital Growth components.
*1 July 2015. Performance figures for more than 1 year are annualised, calculated after all applicable fees and taxes.
**Portfolio return is based on the change of the unit price including distributions but excluding franking credits. Franking credits will enhance portfolio returns and historically, have added about 0.2% pa to Fund returns as shown in the last column of the table above.

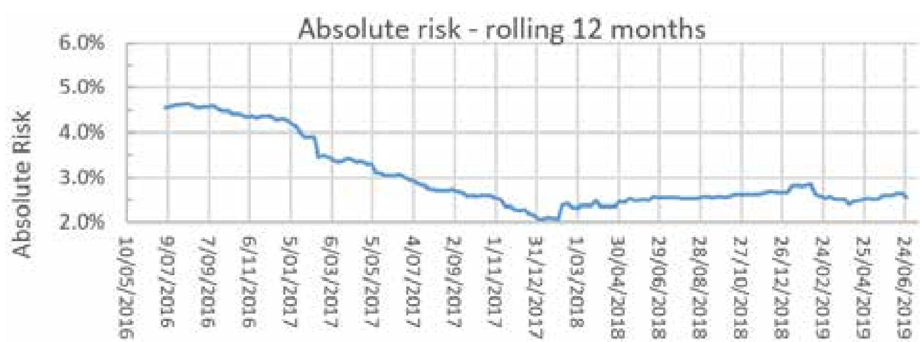
As shown in the Table above, the Fund's total return has been consistently in the range of 5% to 7% pa since inception with the majority of the return derived from income, ahead of our stated return objective. In the Table below, we have tabulated the risk (as measured by the annualised standard deviation) of the Fund over 1 - 3 years and since inception and compared this with the ASX200. The risk of the Fund is far less than the equities market, less than 3.3% in absolute terms and less than 30% of the ASX200 since inception. These risk outcomes are well below the Fund's objectives of absolute risk of 4.0% ± 1.0% and relative risk of less than 40% of the ASX200 Index, demonstrating our superior risk management process.

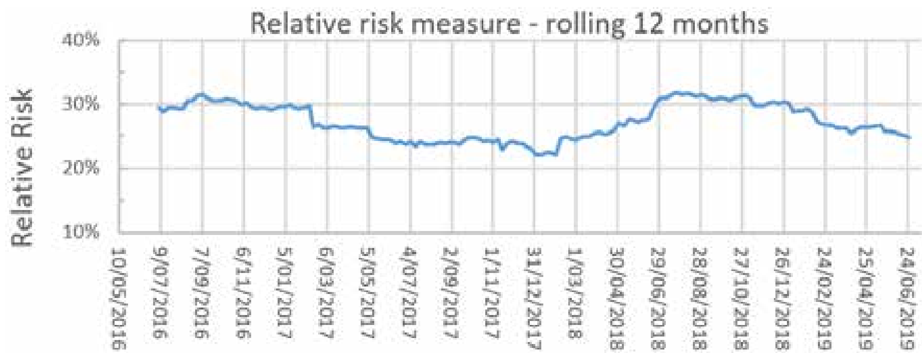
The absolute and relative risk on a 12m rolling basis are plotted in Figure 1 below. From these shorter rolling periods, we see the absolute risk has not breached the 5% maximum risk since inception. On a relative basis, the rolling 12m relative risk is below 40% of the ASX200 over the entire period. Thus, whether you consider risk over a longer fixed period or on a rolling 12-month basis, we have managed the risk well, and that has provided the price stability of the Fund while generating attractive total returns. Figure 2 showed this total return on cumulative return basis compare to the RBA cash rate + 3.0% pa return objective. This has resulted in a superior Sharpe ratio (discussed below).

The Fund's June quarter distribution is 2.8387 cents / unit (including franking), and the rolling 12-month income generation is 4.6%. This is consistent with the Fund's income investment objective of providing meaningful income above the RBA cash rate.

	Volatility^			
	CAIF	ASX200	Ratio of CAIF/ASX200	Sharpe Ratio^^
1 year	2.6%	9.5%	0.26	1.92
2 year	2.6%	9.5%	0.26	1.58
3 year	2.7%	10.6%	0.26	1.70
Since Inception	3.2%	11.8%	0.27	1.49

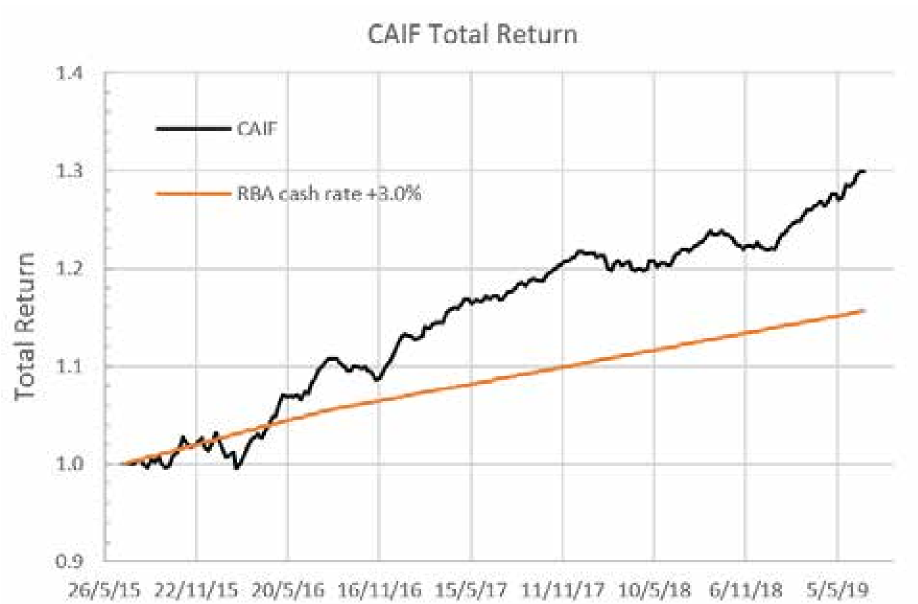
^Volatility is the annualised standard deviation of the NAV/unit as measured on a weekly basis.
^^Sharpe ratio is calculated on a monthly basis.





Source: Clime Asset Management, IRESS

Figure 1. The absolute risk (top) and relative risk (to ASX200) of the Fund using weekly prices since inception. The Fund has shown superior absolute and relative risk attributes since inception.



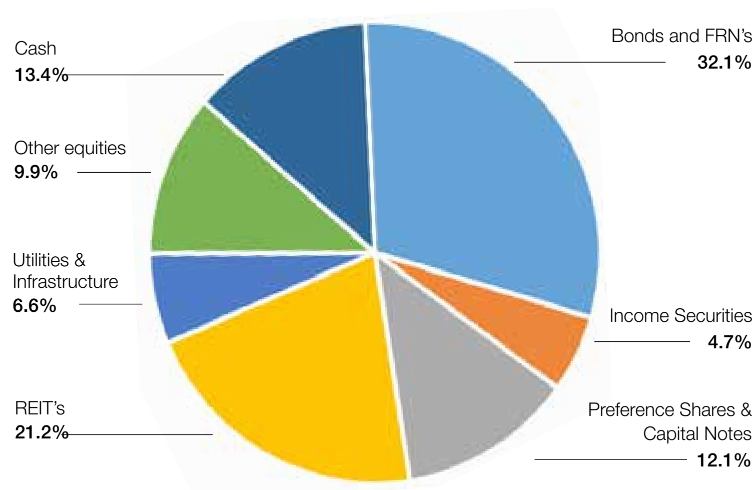
Source: Clime Asset Management, IRESS

Figure 2. Total Return of the Fund since inception. The orange line objective return is the RBA cash rate + 3% pa.

The Sharpe ratio was developed by Nobel laureate William F. Sharpe and is used to help investors understand the return of an investment compared to the risk undertaken to achieve the return. The ratio is the average return earned in excess of the risk-free rate per unit of volatility or total risk.

The Sharpe ratio tabulated above has been consistently positive over the entire period. A positive number above 0 indicates that we have added value by taking the additional risk to achieve a return above the risk-free rate. A positive number closer to or above 1.0 is considered a strong risk adjusted return. In this case, we have achieved that.

Asset Allocation



Top 5 Holdings

Security	Weight %
Multiplex Convertible Note	2.7%
CBA Capital Notes (CBAPD)	2.4%
MBLHB Perp Notes	2.4%
National Bank NABHA	2.3%
Centuria Diversified Property Fund	2.2%

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Distributions

Period Ending	Wholesale Units (cents per unit)
30 June 2019	2.5854 (+0.2533 franking credits)
31 March 2019	0.8096
31 December 2018	0.8859
30 September 2018	0.8045
30 June 2018	1.8352 (+0.2025 franking credits)
31 March 2018	0.7455
31 December 2017	0.7602
30 September 2017	0.6015
30 June 2017	1.8451 (+0.3189 franking credits)
31 March 2017	1.0082
31 December 2016	0.9706
30 September 2016	0.5123
30 June 2016	2.1483 (+0.3153 franking credits)
31 March 2016	0.8246
31 December 2015	0.2390
30 September 2015	0.5383

Investment Commentary

At 30 June 2019, the Clime Australian Income Fund was diversified across six underlying sub-asset classes: Domestic Debt; Income & Preferred Securities; REITs; Utilities & Infrastructure (U&I); Equities; and Cash. Note REITs and U&I are also equities, but they are normally classified as a sub-set of the equity asset class. The underlying security weights in the portfolio ranged from around 0.5% to 3.0%.

In the June quarter, the Fund's strategic asset allocation (SAA) and tilts within each asset classes included:

- Increased exposure to credit rated Floating Rate Notes (FRNs),
- Positioning the Fund to fixed rate debt securities with short to midterm maturities to lock in fixed rates;
- Selectively increasing exposure to attractive REITs but also taking profits at the individual security level due to the strong rally of bond prices that began around March.

As such, we participated in the following FRNs / Bond issuance in the primary market:

- The new Peet Limited OTC 5y fixed rate bond,
- NAB OTC T2 10y, 5y non-call subordinated T2 FRN,
- Members Banking Group 3y senior debt,
- NextDC June 2022 fixed rate bond.

All the above were in high demand to various degrees and closed well over-subscribed. During the quarter, we bought Westpac Corporation OTC subordinated Tier 2 FRNs in the secondary market.

In the capital notes / preference share asset class, we topped up Ramsay Healthcare preference shares (CARES) and Macquarie Capital Notes (MQGPD) with fund flows.

In the equity basket (including REITs and U&I), we participated in the Arena REITs (ARF) and GPT Group (GPT) capital placements in May and June respectively. We topped up Charter Hall Educational Trust (CQE), AGL Energy Limited (AGL) and Wesfarmer Limited (WES) on weakness during the quarter.

We sold Iress Limited (IRE) for a good profit after a strong run. You may recall that we participated in the ASX Limited selldown on IRE in the March quarter 2019 at a discount and as it rallied well beyond our valuation, we decided to take profits. IRE is a quality company but in line with our disciplined approach, we take profits when valuations are richly exceeded. In replacement, we introduced Premier Investments Limited (PMV) as we see value there and good fully franked dividends over the midterm.

Outlook

Since late 2018, there has been a dearth of positive domestic and global economic data. On the contrary, we see geopolitical risk increasing and slower growth with muted inflation.

The RBA cut the cash rate from 1.50% to 1.25% in June 2019, its first move in rates since August 2016. They cut again in July to an all-time low of 1.0%. Globally, we have seen central banks turning dovish and signaling further stimulus / cuts in the future.

The Australian 10y bond price rallied sharply from 1.78% to 1.33% (yield moves in opposite direction to price) since the beginning of the quarter. It touched an all time low of 1.27% in late June. Similarly, US 10y Treasuries were at 2.41% at the beginning of the quarter and finished at 2.01%. The US 10y and 3-month Treasury yield curve is now inverted: historically this has been one of the better indicators of a US recession 4 - 5 quarters ahead, implying the possibility of recession in 2020. Whether this materialises or not we cannot be certain, but the interest rate market is beginning to price in further rate cuts in the US and the tightening cycle was curtailed abruptly.

Globally, the amount of negative yielding bonds has reached US$12T, a sign that not all is well in the world economy. Nevertheless, equity markets continue to rally, encouraged by dovish central banks and rate cuts.

In our view, the global economy is stuck in a low growth environment. Just when the investors thought it would normalise in the first half of 2018, the global economy showed signs of weakness which rolled over to 2019 as elaborated in the March 2019 quarterly report.

This is further complicated by recent US-Sino trade and other geopolitical tensions which will exacerbate the fragile growth since the GFC. Furthermore, we see further downside risk to the trade tensions as rivalry between the top two economic powers for technology supremacy ratchets up. This will likely take multi-years to “play out”. Investing in such an environment requires extra care for a lower risk / higher yield fund.

We have identified high debt levels amongst public and private sectors, negative demographics, technology and a slowdown in China as the main forces that will shape the global scene. To this, we have added climate change as the overarching risk factor, and of course the US-Sino confrontation. These macro-themes inform our asset allocation decisions. We actively tilt our asset allocation to maximise return while minimising risk in a dynamic manner periodically.

Given this backdrop, is the Australian economy heading to a major slowdown or recession? In short, we think this is dependent on two major factors: fiscal policy and China. On both factors, we are somewhat optimistic because we begin this slowdown with low government debt and thus the Government has room to move, e.g. tax cuts and / or infrastructure spending.

On China, there are quite a few levers the central Government can pull to modulate the slowdown in their economy despite trade tension with the US. Moreover, if China slows down too quickly, it is likely that they will create more growth through infrastructure and other fixed investment spending. Any stimulus in the form of infrastructure and fixed investments will be positive for Australia’s resources sector and thus may cushion adverse impacts on the Australian economy.

For the Fund, as we see risk increasing, we will adhere to the aim of generating meaningful income higher than the RBA cash rate yet doing this with relative price stability. Furthermore, we will seek to:

a. improve on the income component. The annual income yield of 30 June 2019 is 4.6%, which is well above the RBA cash rate of 1.00%. That said, it is possible that the RBA will cut rates further and thus we believe investors should adjust their expectations to a lower yield environment accordingly;
b. maintain price stability of the unit price;
c. take advantage of market volatility to accumulate high quality, lower risk, yield-focused securities across the capital structure;
d. take profits at the security level if any individual security runs too hard so that realised capital gains can be distributed for all unitholders, augmenting the income component of the Fund’s distribution.

Thank you,

Vincent Chin, Portfolio Manager - Multi-Asset Income Strategies