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Integrity Transparency Conviction

Monthly Investment Reports

April 2019

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Market Commentary

Global markets have performed strongly over the first four months of the calendar year. US markets are at, or close to, record levels; many European markets are within a few percentage points of recent highs; and in Australia, the S&P/ASX 200 price index is closing in on its previous record high of 6,851 reached in October 2007, almost 12 years ago.

The bellwether markets remain in the US. The S&P 500 and NASDAQ have rallied to close at record highs as earnings are coming in slightly better than expected. The Dow Jones has been held back slightly by Boeing's problems with the grounding of the 737 Max but is within touching distance of its record high of last October.

More than 78% of the S&P 500 companies that have reported have surpassed analyst expectations, according to FactSet data. But the major movement in the market over the last few months is not exclusively earnings driven. The S&P 500 has risen 16.4% so far this year with the help of a dovish Federal Reserve and the market belief that the central bank is determined to extend the decade-long economic recovery, even if inflationary pressures begin to emerge.

The upward thrust in sharemarkets has surprised many with its vigour. The new highs come after some indicators in the US bond market had pointed to a potential recession (more about this below) and as investors prepared themselves for a challenging first-quarter reporting season. Commentators feared that S&P 500 earnings might show a year-on-year decline for the first time since 2016. But early signals have suggested that is too pessimistic, with forecasts for modestly positive earnings growth again emanating from US reporting season.

If the so-called 'earnings recession' is more phantom than fact, then should we embrace this market and join the party? The weight of evidence is delicately poised. On the one hand, global central banks are clearly supportive of low interest rates and very cheap money – largely because the threat of inflation has failed to materialise despite reasonable economic growth and low unemployment in many developed economies. The Phillips Curve – which describes a close relationship between full employment and rising inflation – has not been in evidence so far.

The Fed pledged in January to be 'patient' before tightening monetary policy further, and then forecast in March there would be no further rate rises in 2019. In April, it said the next rate move could be in "either direction". US Federal Fund Futures are signalling a better than even chance of the Fed cutting rates by the end of this year. That has given investors confidence to buy high-growth stocks, particularly in the technology sector. This sector was among the hardest hit in the final quarter of 2018, when signs of a slowing global economy emerged and the Fed was still keen to tighten monetary policy.

Technology sector performance data illustrates the strength of the rebound; the NASDAQ was up 4.7% in April, taking its one-year return to 14.6%. Australia's emerging tech sector more than followed suit, with the S&P/ASX300 IT sector up 7.4% and 31.7% for the month and year, respectively.

Other signs of encouragement include some stabilisation of growth in China, the expectation of a deal coming out of Sino-American trade negotiations, and the delaying of a 'hard Brexit' with the European Union extending the deadline for the UK's departure to 31 October 2019.

On the other hand, a number of concerns remain.

Some analysts are concerned about the recent inversion of the yield curve — when short-term borrowing rates rise above long-term ones — which has been a powerful indicator of impending recession in the past. Some economists have suggested that the yield curve has been sending out misleading signals for a while. It has been argued that the distortions created by extraordinary post-crisis monetary policies have led to a breakdown in the relationship between interest rate expectations and economic growth.

In addition, valuations are somewhat challenging. Price Earnings Ratios are relatively high in many markets, particularly for US equities, which means that a negative shock could trigger a correction. US corporate profit margins are historically elevated and thus vulnerable to a fall should there be an increase in production costs – particularly with labour market conditions stretching tighter by the month.

There are heightened risks associated with US corporate-sector debt, owing to the prevalence of leveraged loans and firms whose bonds have been downgraded from investment-grade to 'junk' status. The commercial real estate sector is burdened with overcapacity, as developers over-built and e-commerce sales have undercut demand for physical retail space. Against this backdrop, any signs of a growth slowdown could lead to a sudden increase in the cost of capital for highly leveraged firms.

The next risk is that hopes of a resolution to the trade war may be misplaced. Even with a deal, the conflict could escalate again if either side suspects the other of not holding up its end, or if it serves either Trump's or Xi's political purposes. Other simmering trade tensions may also boil over, if Congress fails to ratify the Trump administration's revised North American Free Trade Agreement, or if Trump follows through with import tariffs on cars from Europe.

European growth is fragile, and could be hindered by a strong showing by populist parties in the upcoming European Parliament elections or another political or economic crisis in Italy. This would come at a time when monetary and fiscal stimulus in the eurozone is constrained and eurozone integration has stalled.

Conclusion

World growth, low inflation and low interest rates have combined to lift equity markets and added to balanced portfolio returns after a poor December 2018 quarter. From this point, we see "more of the same" in terms of the macro environment, but we suspect that equity returns will slow somewhat as equity markets have work to do (i.e. grow corporate earnings) following such a strong rally.

We are neither bullish nor pessimistic on the world outlook, and the rally in equity markets is explainable by the interplay of macro factors. From this point, we believe that a strong quality-focused and valued-based investment approach is needed to identify and access opportunities in this world of low growth.

Given the finely balanced economic environment articulated above, we remain measured in our approach to asset allocation and portfolio positioning. In equity portfolios, we have taken some recent opportunity to rebalance portfolios in the interests of capital preservation. Our strong cash positions afford us optionality should market wide volatility re-emerge in coming months.

Thank you for your continued support of Clime.

Adrian Ezquerro
Head of Investments

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Clime Australian Value Fund

The Clime Australian Value Fund delivered a return of 5.6% (Wholesale Units, net of fees) for the month. This was a pleasing outcome when compared with a 2.4% return for the S&P/ASX200 Accumulation Index.

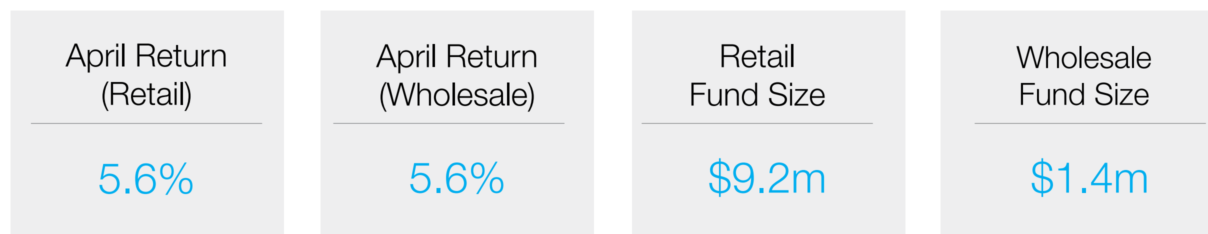
The continuing rally has provided an opportunity to trim existing positions that have appreciated to value while further rebalancing the portfolio.

Key contributors for the month were Jumbo Interactive (JIN, +32.8%), Navigator Global Investments (NGI, +28.9%), Afterpay Touch (APT, +22.4%), Austal (ASB, +18.7%), Webjet (WEB, 15.9%) and Treasury Wine Estates (TWE, +15.2%).

Key detractors for the month were Citadel (CGL, -7.0%) and Lycopodium (LYL, -6.0%).

Reflecting a measured outlook and portfolio position, as highlighted above, we remain well placed to deploy capital should market wide volatility re-emerge in coming months.

Snapshot



Fund Performance (30/04/19)

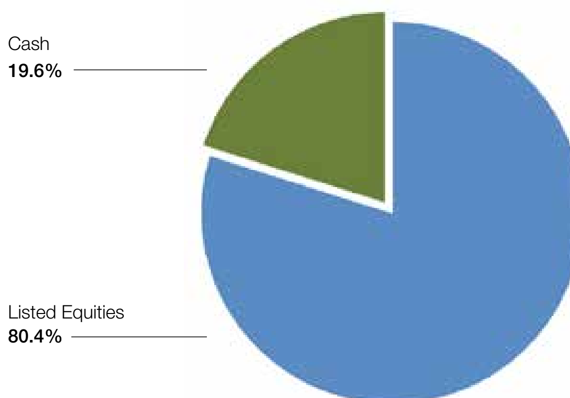
	1 month	3 months	6 months	1 year	3 years*	5 years*	Inception*
Retail (AUD Portfolio Return)	5.6%	13.5%	13.1%	15.6%	10.1%	4.5%	6.6%
Wholesale (AUD Portfolio Return)	5.6%	13.6%	13.2%	15.8%	10.3%	4.7%	5.7%

Inception: Retail Units: 28 August 2006; Wholesale Units: 15 April 2011.
*Performance figures for more than 1 year are annualised, calculated after all applicable fees and taxes. Performance figures compare unit price to unit price for the given period. The returns exclude the impact of imputation.

Distributions

Period Ending	Retail Units (cents per unit)	Wholesale Units (cents per unit)
31 December 2018	1.0879	0.9481
30 June 2018	1.3075	1.2652
31 December 2017	1.6705	1.2670
30 June 2017	1.7233	0.9930

Asset Allocation



Top 5 Holdings

Security	Code	Weight%
Amcor Ltd	AMC	5.0%
Wesfarmers Ltd	WES	4.4%
Webjet Ltd	WEB	4.4%
Credit Corp Ltd	CCP	4.3%
National Australia Bank Ltd	NAB	3.9%

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