

Clima Australian Value Fund
Monthly Investment Report
July 2019



Market Commentary

July saw a continuation of strong bond and share markets across the globe as central banks reaffirmed their commitment to keep interest rates low. In such an environment, investors were attracted by the superior yields available from capital markets, and this appears likely to continue for some time – perhaps until economic data suggests a severe slowdown is imminent, or corporate results disappoint expectations.

ASX at record high

At month end, Australian stocks were trading at or close to record highs, finally eclipsing the level reached just before the onset of the GFC in November 2007. Amongst the main markets, China, France and Italy are amongst the few countries yet to breach the pre-GFC record, whereas the US and UK markets surpassed their peaks back in 2013. Indeed, the main US index, the S&P 500, is now trading around 90% higher than its previous peak in October 2007.

What held the ASX back for so long?

Gains in the ASX had been limited by a relatively high aggregate payout ratio, tight monetary policy, the strong Australian dollar and weak commodity prices between 2014 and 2017. So far this calendar year, the ASX has climbed about 20%, supported by two interest rate cuts, the return to government for the Liberal National Coalition, a bottoming in the residential property market, and surging commodity prices (particularly iron ore).

The ASX has heavy representation from financial stocks and resource companies: a strong rally in big banks, and powerful performances from the major diversified miners (BHP and RIO), has fired up the index. High dividends (the ASX/S&P 200 index yields on average around 4.5%) have also attracted investors, who are struggling for yield in an ultra-low interest rate environment.

Wall Street at record high

Wall Street's main indices closed at or near record highs at month end following the Federal Reserve bolstering expectations of interest rate cuts during August. The markets expect the Fed will reduce its policy rate by 0.25% in what has been dubbed "an insurance cut". The promise of new stimulus measures has boosted prices of Treasuries and shares, with investors betting US borrowing costs will stay lower for longer than they thought just months ago.

The US economy is enjoying its longest uninterrupted stretch of expansion since the 1850s, despite the eurozone crisis, slowdown in China, and trade wars. Recessions are typically defined as two consecutive quarters of shrinking gross domestic product. The National Bureau of Economic Research (NBER) – the semi-official arbiter of US booms and busts – reckons the current expansion started in June 2009. That means that last month the US expansion hit its 121st month, making it more than twice as long as the average post-WWII expansion.

This year, the US economy expanded at an annualised rate of 3.2% in the first quarter but has since slowed to a rate of 2.1% in the second quarter.

Some commentators worry that the expansion will probably end soon. As uncertainty around trade policy remains unresolved, manufacturing data around the world drops markedly, and

inverted yield curves signal disturbing trends, concern about the outlook is becoming more pronounced. Business confidence and corporate investments have slowed to multiyear lows.

Major institutions like the World Bank and the IMF highlight trade tensions

According to the World Bank's economists, "Global growth has continued to weaken and momentum remains fragile. Downside risks to growth predominate, including rising trade barriers, a build-up of government debt, and deeper-than-expected slowdowns in several major economies." The post GFC recovery has been weaker than most other economic recoveries since the second world war. US GDP is now about 20% bigger than its pre-GFC peak. In contrast, the 1990s boom increased the size of the US economy by about 40%.

The International Monetary Fund (IMF) has cut its growth forecasts for the global economy for this year and next. It says there is an urgent need to reduce trade and technology tensions. It predicts growth of 3.2% in 2019, down from its April forecast of 3.3%.

The IMF listed the principal risk factor to the global economy as being "further US-China tariffs, US auto tariffs, or a no-deal Brexit – all of which could sap confidence, weaken investment, dislocate global supply chains, and severely slow global growth below the baseline".

Global manufacturing recession

A major economic concern is the global manufacturing slowdown. Manufacturing indicators are showing worsening conditions across the globe, especially in the US, China, Japan and Europe. Pressures in the auto sector and concerns over tariffs have played a big role. The global manufacturing Purchasing Managers' Index (PMI), a survey of manufacturer sentiment, suggests a global manufacturing recession.

So far, the downturn has been concentrated in manufacturing, while the much larger services sector has shown resilience. Services tend to be less cyclical than manufacturing, and the expansion of services output and employment is one reason why the economic cycle has been so elongated.

High levels of employment and rising household incomes, characteristic of the late stages of the business cycle, have combined to sustain services sector growth over the last nine months. But it is unclear if the services sector can continue to keep the economy out of recession if manufacturing continues to contract.

The global economy is soft, even as markets rise

Share market valuations are not at extreme levels, but they are above historical averages. High valuations are also why equity markets would be vulnerable to earnings disappointments.

Extreme valuations are not in themselves usually the cause of collapse in share markets. Typically, bear markets in Australian shares (a fall of more than 20%) follow declines in US markets. Over the last six decades, the ASX All Ordinaries Index has suffered 8 bear markets, where stocks fell

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on average by 37%, and lasted on average for 16 months. Bear markets have typically occurred every 7 or 8 years.

US bear markets usually coincide with American economic recessions. Past experience shows correlations between recession, rising bond prices (falling yields) and declining share prices. If the US economy experiences a recession, and corporate earnings collapse, it seems likely that stock prices in the US (and probably also in Australia) will fall as well.

The four most useful indicators of an imminent recession in the US are: a rapid increase in the unemployment rate; an inverted yield curve; and sharp falls in the ISM manufacturing index and consumer sentiment. Employment remains strong at present, with the unemployment rate at a 50-year low. However, the yield curve is inverted and sending a troubling message, and both the manufacturing and the consumer sentiment measures are flashing yellow.

While central banks maintain their dovish stances, investors will probably continue to embrace risk-taking, even if it means share prices are expensive. But we should pay attention to the various risks, including the slowdown of growth rates (especially manufacturing and more importantly, services), the difficulty of further reducing interest rates from already ultra-low levels, and rising trade and geopolitical tensions. For equity markets, the weaker macro environment has not yet had a material impact on earnings, but this may become evident in the next reporting season.

A recession is far from inevitable - but the capacity for a decisive response (such as occurred in 2008/9) has been reduced. Back then, central banks either cut rates, bought up bonds, extended government backing to the financial sector, or did all of those things. This time around, it may be more difficult.

Thank you for your continued support of Clime.

Adrian Ezquerro
Head of Investments

Clime Australian Value Fund

The portfolio returned 1.1% in July, net of all fees and taxes, compared to a 2.9% return for the S&P/ASX200 Accumulation Index and a 3.0% return for the S&P/ASX All Ordinaries Accumulation Index.

In an effort to further improve the portfolio running yield in an increasingly low interest rate environment, leading utility AusNet Services (AST) and AREIT Growthpoint Properties Australia (GOZ) were added to the portfolio during the month. Both stocks display lower share price volatility, have high quality asset bases and offer attractive and rising yields above 5.5% at current prices.

Key contributors and detractors to the portfolio return for the month were:

- Australian Equity Large Cap Sub-Portfolio: Positive contributors Treasury Wine Estates (TWE), National Australia Bank (NAB), CSL (CSL) and Wesfarmers (WES), detractor Amcor (AMC).
- Australian Equity Mid Cap Sub-Portfolio: Positive contributors Afterpay Touch (APT) and Orora (ORA), detractors Credit Corp (CCP), GUD Holdings (GUD).
- Australian Equity Small Cap Sub-Portfolio: Positive contributors Macquarie Telecom (MAQ) and Lycopodium (LYL), detractors Navigator Global Investments (NGI) and Audinate (AD8).

The portfolio enters reporting season with solid cash reserves, which in turn provides scope to selectively add exposure to high quality companies over the coming months, should sensibly priced opportunity become apparent.

Distributions

Period Ended	Retail Units (cents per unit)	Wholesale Units (cents per unit)
30 June 2019	1.0980	1.0491
31 December 2018	1.0879	0.9481
30 June 2018	1.3075	1.2652
31 December 2017	1.6705	1.2670

Snapshot

Portfolio Return (Month) Retail	Portfolio Return (Month) Wholesale	Retail Fund Size	Wholesale Fund Size
1.1%	1.1%	\$9.1m	\$1.1m

Fund Performance (31/07/19)

	1 month	3 months	6 months	1 year	3 years*	5 years*	Inception*
Retail (AUD Portfolio Return)	1.1%	2.0%	15.8%	11.0%	9.5%	4.3%	6.6%
Wholesale (AUD Portfolio Return)	1.1%	2.1%	15.9%	11.2%	9.7%	4.5%	5.8%

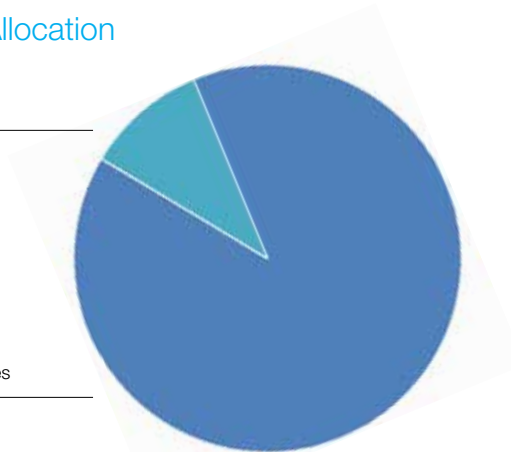
Inception: Retail Units: 28 August 2006; Wholesale Units: 15 April 2011.

*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.

Asset Allocation

Cash & Fixed Interest
10.1%

Listed Equities
89.9%



Top 5 Stock Holdings

Security	Code	Weight%
National Australia Bank Ltd	NAB	5.6%
Westpac Banking Corporation Ltd	WBC	5.4%
Amcor Ltd	AMC	5.1%
BHP Billiton Ltd	BHP	4.4%
Bravura Solutions Ltd	BVS	4.0%