

Clima Australian Value Fund  
Monthly Investment Report  
August 2019



## Market Commentary

After seven months of consecutive positive returns since the December quarter, the markets turned more volatile in August. Factors contributing to the volatility included a smaller than expected rate cut from the US Federal Reserve; slowing in the US, China, Germany and Japan; the risk of a no-deal Brexit; continued popular unrest in Hong Kong; and rising US-China trade tensions.

Amongst all these risks, we view growing US-China trade tensions as the most alarming in relation to global economic growth and its threat to markets. To make matters worse, following the Fed rate cut at the end of July, Chair Jerome Powell implied that the 0.25% cut should be viewed as “a mid-cycle adjustment” of its interest rate policy, rather than the start of a major rate lowering cycle – not a view that the markets welcomed.

Government bonds fell in yield across the developed world. Australian 10-year bonds continued to make all-time lows, with the yield ending August at 0.89%, down 0.3% from the start of the month. US 10-year Treasuries finished August at 1.50%, a drop of 0.5% over the month. German government bonds maturing in 10 years now yield -0.70%, while Japan's 10-year debt yields -0.27%.

The global collapse in bond yields is disturbing. It may mean one of a number of things, or a combination of factors, namely that bonds are in a valuation bubble, or that the global economy is at heightened risk of a major recession, or that inflation is dead and buried. None of these factors are particularly amenable to the strong performance of investment markets. Whatever the cause, the widespread emergence of negative yielding bonds is unsettling for investors, and especially for those dependent upon fixed income securities for their retirement income.

### The world's largest economies are showing signs of slowing

Several major economies are showing signs of slowing, including the United States, China and Germany. In the United States, many observers are focused on the inverted yield curve, which may suggest recession ahead.

#### The United States

While the United States economy is growing at around 2% and keeps adding jobs at a healthy rate, President Trump's trade war with China is causing uncertainty in business decision-making. Corporate investment spending is softening. A key measure of business capital spending in the United States, fixed non-residential investment (essentially investing in new plant and machinery to produce goods), was in negative territory in the second quarter. In factories, the rate of production growth has slowed for six consecutive months, according to the Institute for Supply Management's index. This measure has now turned negative, indicating contractionary conditions in the latest August reading, and the weakest result in three years.

US corporate insiders (directors, substantial shareholders and senior executives) are ramping up the sale of shares in their own companies. Insider selling has averaged \$600 million of stock per day in August, according to TrimTabs Investment Research, which tracks stock market liquidity. August is on track to be the fifth month of the year in which insider selling has topped \$10 billion. The only other times that has happened was 2006 and 2007, the period just before the last bear market in stocks.

The key question becomes whether this loss of confidence remains confined to the business sector, or whether it spreads to the consumer. In 2018, consumer spending accounted for 69% of US GDP, versus 18% for business investment (with a large part of the remainder accounted for by government spending). To date, American consumers are still spending, but that could change quickly. A sell off in global markets could reduce consumer confidence; and if businesses pull back on investment spending, they may also commence layoffs, hiring freezes and cuts to overtime, crimping consumers' incomes.

The University of Michigan survey of consumer sentiment fell sharply in its August reading, to its lowest level since the start of the year. Were consumer spending to decline sharply, there are additional risks that could make the situation worse, such as the increase in corporate debt. Businesses have taken on more debt in this era of ultra-low interest rates, which leaves them vulnerable to failure if the economy were to soften or interest rates were to rise. A pullback because of trade wars could cause a wave of bankruptcies that turns a mild slowdown into something worse.

Furthermore, an erratic and unpredictable President Trump and a partisan Congress might be unable to find common ground in stimulating the economy. In early 2008, for example, as the last recession took hold, President Bush negotiated a \$152 billion stimulus package with the Democratic Congress to lessen the recession's impact, but it is questionable whether Trump would be able to gain a consensus, particularly considering the timing as the US heads towards the election in November 2020.

#### China

China's economic system has been under pressure over the last year or two. China depends on exports, and following tariffs imposed by its biggest customer, the United States, the country has significant challenges. China derives 4% of its gross domestic product from exports to the United States, while the US derives only about 0.5 percent of its GDP from exports to China. US multinationals like Apple depend on China for both production and consumption, and a slowdown there will be reflected in their earnings. But the most significant consequences will be felt in China, not the US.

Economic growth dipped to a 27-year low in the second quarter, and the economy likely will continue to falter in Q3 amid the trade war with the US. Throughout January to July, investment growth slowed, while in July, industrial production expanded at a near two-decade low and retail sales growth moderated.

Uncertainty linked to the trade war will continue to weigh on the economy, while weak global demand and domestic economic imbalances pose further risks to the outlook. Nevertheless, fiscal stimulus and accommodative monetary policy should buttress the economy and make the government's 6.0% to 6.5% growth target for this year attainable.

#### Germany

Germany is the closest to slipping into the classic definition of recession. Exports account for nearly 50% of its GDP – disproportionate for the fourth largest economy in the world and a number that makes it vulnerable to belt-tightening in other countries. This creates two different risks. The largest buyer of German exports is the US, and if the US slips into recession, it will purchase fewer

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imports. If Germany falls into recession, it won't be able to buy from its customers in the rest of Europe. These countries depend heavily on their exports to Germany, so if the German economy contracts, the rest of Europe suffers.

The economies in the eurozone countries overall grew by 0.2% over the last quarter, half the 0.4% growth rate posted in the first three months of the year. On an annual basis, the economy rose just 1.1% from the same quarter a year ago.

Europe's banking system is vulnerable, with the negative interest rates prevalent across the continent. The European Central Bank will be keeping a close eye on banks likely to fail; these are troubling signs considering that banks are important bellwethers of the economy.

With three of the top four economies in the world facing simultaneous slowdowns, and Japan trying to deal with its own challenges, the risk is accentuated by the feedback effect between these economies. A simultaneous downturn in different countries triggered by different reasons could be more dangerous than one sparked by a single factor. China and Germany need to export more. The US wants to import less. The solutions to each of these countries' economic problems may grind against each other.

### Australia

Meanwhile, Australia's economy is growing at its slowest pace since the global financial crisis, as cautious consumers keep a tight lid on spending in spite of a surge in the nation's exports. Figures released in early September show household consumption — which makes up almost 60% of the economy — dropped to 1.4% in the year to June, down from 1.8% three months earlier. The economy grew 1.4% over the same period, down from 1.8% — a weak performance given that booming commodity exports produced Australia's first current account surplus since 1975.

The first current account surplus in 44 years reflects strong resource export volumes (coal, LNG, iron ore), high prices (esp. for iron ore), strong services exports (tourism, education), and reduced imports after the end of the mining investment boom.

### Is global recession looming?

The United States is not in a recession. It may avoid one altogether, for the foreseeable future. But the risks that the US will fall into recession within the next year or two have increased. The economies in China and many of its Asian neighbors are getting weaker, partly as a result of the trade war with the United States. The European economy has been troubled with low growth for years

The trade war between China and the United States has made it difficult for many global firms to plan their operations — and it may lead them to sit on their hands rather than invest. Companies do not know whether tariffs will go away soon or be a continuing cost of doing business; they are not sure whether to shift their supply chains out of China or wait and see what happens. Google recently announced that it is shifting its Pixel smartphone production from China to Vietnam. At present, few companies are actively adding new investments to their plans.

Furthermore, international coordination would be hard in the current geopolitical moment. In the fall of 2008, finance ministers and central bankers of the Group of 20 major economies released a joint statement pledging to work together to end the financial crisis. With many nations facing inward, it is hard to imagine that occurring today.

The list of risks above is troubling for investors — even long-term investors who are prepared to look through temporary volatility. We are generally holding somewhat elevated levels of cash in most portfolios as a risk mitigation tactic, as well as to take advantage of volatility to invest in attractive stocks at reduced prices.

Bear markets generally coincide with recessions for good reason: during recessions, corporate earnings fall and investor appetite to embrace risky equities reduces. Yet in a world with such low rates available on savings, some argue that there is no alternative to investing in the capital markets.

In any event, and few can be confident in predicting the future, there are practical, sensible solutions to ensure investment portfolios are resilient. Strategies include diversifying across asset classes, including cash (even if the return from cash is miniscule); ensuring asset allocation is fit for purpose; selecting equities which are less risky, by focusing on high quality companies; and keeping a focus on yield.

We end with some wise words from Howard Marks, the famed investor from Oaktree Capital:

*"Investing is not black or white, in or out, risky or safe. The key word is calibrate. The amount you have invested, your allocation of capital among the various possibilities, and the riskiness of the things you own all should be calibrated along a continuum that runs from aggressive to defensive."*

Thank you for your continued support of Clime.

**Adrian Ezquerro**  
Head of Investments

## Clime Australian Value Fund

The portfolio returned -1.0% in August, net of all fees, compared to a -2.4% return for the S&P/ASX200 Accumulation Index and a -2.2% return for the S&P/ASX All Ordinaries Accumulation Index.

The August reporting season proved to be a softer month for global markets, with most indices paring back recent gains. Defensive sectors including healthcare and real estate once again outperformed, with materials and energy weaker.

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

- **Australian Equity Large Cap Sub-Portfolio:** Positive contributors Treasury Wine Estates (TWE) and CSL (CSL), detractors BHP Group (BHP), Amcor (AMC) and National Australia Bank (NAB).
- **Australian Equity Mid Cap Sub-Portfolio:** Positive contributors Afterpay Touch (APT) and Credit Corp (CCP), detractors Webjet (WEB) and Premier Investments (PMV).
- **Australian Equity Small Cap Sub-Portfolio:** Positive contributors Jumbo Interactive (JIN), Electro Optic Systems (EOS) and Lovisa (LOV), detractors Hansen Technologies (HSN), Navigator Global Investments (NGI) and Citadel Group (CGL).

TWE confounded its doubters, delivering on its guidance of 25% EBIT growth, while healthy cash conversion exceeded expectations. APT's result was well received by the market, with all key metrics ahead of expectations and underlying sales growth of 140%. CCP also enjoyed a strong month, delivering a sound FY2019 result, before announcing the acquisition of Baycorp and upgrading FY2020 guidance. While WEB somewhat tempered growth expectations for the year ahead, the business remains modestly priced relative to its positive long-term outlook. The small cap sub-portfolio was led by strong contributions from JIN, EOS and LOV, with all businesses executing well and reporting upbeat outlooks.

## 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
-1.0%	-1.0%	\$9.0m	\$1.0m

## Fund Performance (31/08/19)

	1 month	3 months	6 months	1 year	3 years*	5 years*	Inception*
Retail (AUD Portfolio Return)	-1.0%	0.2%	9.2%	5.0%	8.8%	3.9%	6.5%
Wholesale (AUD Portfolio Return)	-1.0%	0.3%	9.3%	5.1%	8.9%	4.1%	5.6%

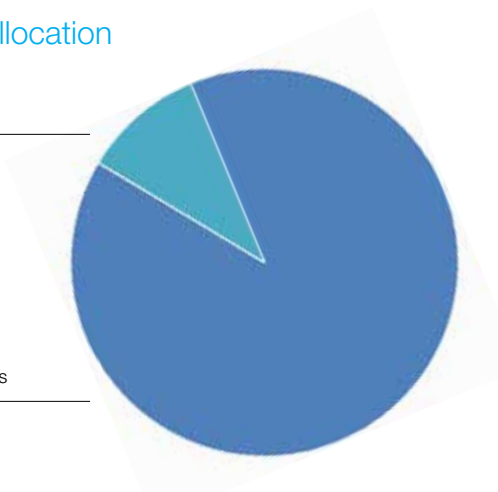
Inception: Retail Units: 28 August 2006; Wholesale Units: 15 April 2011.

\*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  
6.8%

Listed Equities  
93.2%



## Top 5 Stock Holdings

Security	Code	Weight%
Westpac Banking Corporation Ltd	WBC	5.3%
Amcor Ltd	AMC	5.1%
BHP Billiton Ltd	BHP	5.1%
National Australia Bank Ltd	NAB	5.0%
Bravura Solutions Ltd	BVS	4.2%