Integrity Transparency Conviction

Clime Fixed Interest Fund Monthly 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 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.

Market Commentary

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

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Clime Fixed Interest Fund

Clime Fixed Interest Fund (CFIF) was launched for external wholesale clients on 28 May 2019 following being seeded one month earlier. Since then, the RBA has made two consecutive rate cuts of 0.25% each from 1.50% to 1.00%. It is likely that the rate cut cycle in Australia is not quite finished, while overseas, it is possible that the US Fed will cut rates in July. It would be wise for investors to lower future return expectations for the medium term.

In anticipation of these cuts, bond prices across the term curve rallied (yields moving lower) earlier in the year and this trend accelerated in the June Quarter 2019. For example, the yield for 10y Australian bonds continued to move down, touching an all-time low of 1.27% in late June before finishing the month at 1.33%. Ten-year bond yields were 1.78% at the end of March 2019. Similar moves were seen for the 3 and 5 year bonds.

Following the official launch, the Fund begun to invest across various debt instruments, from senior investment grade (IG) debt to high yield (HY) unrated corporate bonds. As the Fund is in its infancy and not fully invested, we have kept the investment profile at the shorter end of the curve (5 years or less).

In June, we participated in two senior Banks' Floating Rate Notes (FRN's): National Australia Bank 5y and Macquarie Bank 3y in the primary market, and bought Westpac 5y senior debt in the secondary market. We participated in the NextDC 3y over-the-counter (OTC) FRN when they tapped the market for additional bonds. During the month, all primary issues were in high demand and margins compressed slightly in the secondary market. We bought Peet Limited HY bond Series II, taking advantage of its cum-interest status. We took the opportunity to invest in a couple of very short dated banks' T2 subordinate FRNs (Commonwealth Bank and ME Bank) to enhance income returns while we await other opportunities.

At month end, the asset allocation was 45% cash (including term deposits), 25% Investment Grade (IG) senior bonds, 24% IG subordinated FRNs and 6% High Yield (HY) unrated corporate bonds. At 30 June 2019, we had not yet invested in Capital Notes and Income Securities.

At 45% cash, the Fund is not fully invested, resulting in a sub-par cash yield for the portfolio. Investors should be aware that at least in the first few months, the monthly distributions may be sporadic and uneven due to the nature of the fund (as interest distributions can only be made on a cash basis). In other words, the Fund cannot make any distributions until the interest from investments have actually been received. That said, the portfolio registered a positive return of 0.35% for June, mainly as the result of accrued interest on investments made but not yet received.

Snapshot

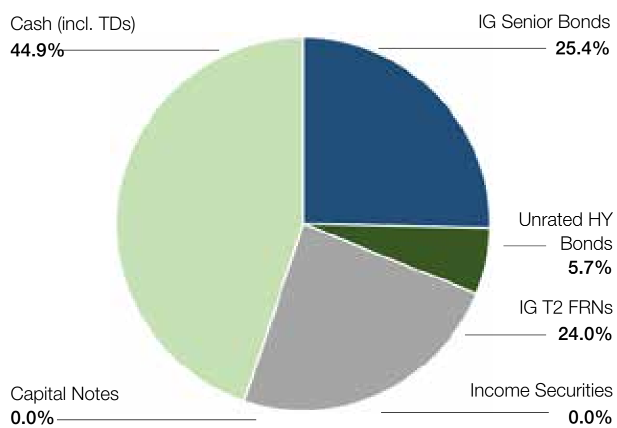
Portfolio Return (Month)	Recent Distribution	Inception Date	Fund Size
0.4%	0.02767 (cents per unit)	08/05/2019	$6.7m

Performance and Volatility of Return (30/06/19)

	1 month	2 months	6 months	1 year	2 years	3 years	Inception
Portfolio Return^	0.4%	0.9%	-	-	-	-	0.9%

^Portfolio return is based on the change of the unit price including distributions but excluding franking credits.
*Inception: Wholesale Units: 28 May 2019. 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 do not include the benefit of franking credits.

Asset Allocation



Distributions

Period Ended	Wholesale Units (cents per unit)
30 June 2019	-
31 May 2019	0.027670