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Clime Fixed Interest Fund

Quarterly Investment Report

September 2019

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Market Commentary

September 2019 Report

Introduction

Markets were volatile over the last quarter, reflecting investor concerns about the US-China trade war and slowing global growth. The mood of the global economy and financial markets is deteriorating: globalization and international trade is under threat; geopolitical risks are rising; negative real interest rates are advancing; and fears of recession are growing. In our view, a recession in the next year or two is far from inevitable, but the risks are greater than at any time since the GFC, and rates are likely to remain at ultra-low levels for a protracted time. For investors, this probably means lower expected returns from their investment assets.

The global economy has been patchy at best: the US and China have slowed to around-trend growth, but Germany, the world's fourth largest economy and the manufacturing powerhouse of Europe, is struggling. Unemployment rates in advanced economies are generally at decade lows, but there are few signs of any inflationary pressures. Markets see accommodative monetary policy as the only solution: cheap money is the means by which "the can is kicked down the road", putting off structural problems until tomorrow. With central bank policy rates so low, advanced economies will be poorly-equipped to counter a recession if one does occur. With the prices of risk assets up over the year, patience has proven to be a virtue so far, and risk taking has been rewarded. However, while we remain steadfast in our view that judicious stock picking will continue to add value, we expect broader asset returns will be below their long-term historical averages over the next few years.

Manufacturing sector struggling

Manufacturing activity is contracting across advanced economies, pointing to the impact of President Trump's trade policies. In the US, a key indicator measuring manufacturing activity in September recorded its lowest level in more than a decade, while global data showed the sector was declining amid fears that trade tensions will escalate further. Output was lower than a year earlier across all 36 advanced economies and sentiment indicators suggest the most geographically widespread manufacturing downturn for seven years.

The global Purchasing Managers' Index in September recorded its fifth month below the 50 mark, the level that divides expansion from contraction. This is the longest period that indicator has been so low since 2012. The PMI for the eurozone fell to 45.7 last month, its lowest reading since October 2012. The Institute for Supply Management index of US manufacturing activity fell more than expected to 47.8, its worst reading since June 2009.

As noted above, Germany is already confronting recessionary conditions, being the most vulnerable large economy to international trade. Germany's leading economic research institute has cut their forecast for economic growth for this year and next, blaming in part "the falling worldwide demand for capital goods." German GDP growth for the year is now forecast at just 0.5%. It can be argued that German industry is now in recession, and this will start to impact the service providers catering to those companies.

In the face of uncertainty and the unpredictability of President Trump, many companies are putting off investment decisions. Others are reckoning with the consequences of higher costs. Although manufacturing is only a small part of the global economy, it is one of the most volatile sectors and often acts as a leading indicator of global economic swings. The World Trade Organization has halved its estimate for trade growth this year, blaming "escalating trade tensions" for the cuts which it said would leave world trade volumes growing only 1.2% this year.

Financial markets

Financial markets have been rattled over the escalating trade war between the US and China as both imposed tariffs and counter-tariffs on imports. Yet despite that, the lack of income returns from cash or fixed deposits has mostly kept shareholders in the markets. Investors' search for "safety" has pushed bond yields to unprecedented low levels, with the yield on 30-year German Bunds turning negative for the first time ever. The US yield curve inverted once again, with yields on 2 year bonds briefly rising above those on 10 year bonds.

There are three factors markets are monitoring. First, markets abhor policy uncertainty, and geopolitical risk is on the rise: President Trump is a wild-card for markets, and inherently unpredictable; and events such as Brexit and the attack on Saudi oilfields are unsettling. Second, the risk of the trade war morphing into a more widespread global currency war is increasing as the US and China compete for global hegemony. And third, political pressures on central banks are mounting. The Federal Reserve has delivered a rate cut and ended quantitative tightening, but President Trump continues to pressure Chairman Powell to do more. Clearly Trump will want rates as low as possible, and the markets as high as possible, at least until the November 2020 Presidential Election.

Investment implications and central banks

What are the investment implications of these various factors? The fall in bond yields is concerning. The capital markets are being supported by ultra-dovish central banks, determined to do whatever they can to extend the economic cycle. To date, expectations of aggressive monetary easing have limited equity market downside in this highly uncertain environment: perhaps this could be called "the Powell Put".

Central banks might help to extend the cycle, but the power of any new measures, such as further lowering rates to almost zero, or purchasing ever more quantities of government bonds, will be less potent than in the past. Eventually, the artificially low cost of capital will either create bubbles in asset prices (we see it in bond markets already) or distort the behaviour of financial markets in ways we do not yet fully understand.

After a decade, central banks are still not observing the inflation they have targeted. Quantitative easing's boost to asset prices has quite possibly become counterproductive – widening wealth disparities, reducing yields and further lowering inflation. All this has been seen before – in Japan, which remains caught up in a decade-long deflationary spiral.

Global equity valuations look attractive when compared with the returns available from cash or bonds, but not when compared with their long term average earnings multiples. Using traditional valuation measurements such as earnings or cashflow multiples suggest equities are mildly overpriced, particularly if the global economy faces further risks of slowing. And yet even though equity valuations are "short of compelling", there are few alternatives that look attractive in this environment.

Market Commentary

Is more easing making the world weaker?

Cutting interest rates from already very low levels might suppress demand rather than stimulate it. In the decade since the GFC, central banks have implemented unprecedented monetary stimulus, both conventional and unconventional, in an effort to boost demand. However, these latter efforts have been largely ineffective and may even have been counterproductive.

On the positive side, lower rates make it cheaper to borrow, thus encouraging investment. Higher asset prices create a wealth effect, which encourages consumption. On the negative side, lower rates reduce income for savers. There are also psychological effects: businesses and consumers worry that if central banks keep lowering rates, there must be a recession in the offing, which undermines confidence. If potential borrowers anticipate further rate cuts down the line, they will defer their borrowing to a later date, thus the lowering of rates can be self-defeating.

On balance, it could be argued that further monetary easing may make the global economy weaker rather than stronger. Because of these offsetting effects, the overall impact of monetary stimulus is difficult to measure. In the US, for example, the shrinking importance of the manufacturing sector - which has fallen from 30% of jobs in the 1950s to 9% today - has reduced the benefit of lower rates in promoting capital spending.

Federal Reserve easing can help boost American exports by pushing the US dollar down, but this does not work if other central banks are trying to do the same thing. Note that the RBA Governor gave as one of his reasons for cutting Australian cash rates the importance of matching overseas cuts in order to keep the AUD from rising and compromising our export competitiveness.

The Australian economy is growing - slowly

The Australian economy is still growing – but very slowly, as evidenced by recent gross domestic product data. In fact, GDP growth is now the weakest since the GFC. Were it not for a big jump in exports due to the high iron ore price and strong government spending, the results would have been worse. The RBA's Governor Lowe remains optimistic that the growth rate will improve, yet he still felt it necessary to lower rates three times this year, justifying the cuts by pointing to the following factors:

• The Australian economy has been going through a soft patch. Over the year to June, GDP grew by just 1.4%, the slowest year-ended growth for some years. The RBA was surprised by the extent of this slowdown.
• While Australia has been less directly affected by the US-China trade disputes than some other countries, there is an indirect effect through slower global growth and increased global uncertainty.
• Over the past year, there has been no growth in consumption per person - unusual when employment is strong. Household disposable income has been increasing only slowly, reflecting subdued wage increases and growth in taxes.
• Slow growth in household income has led people to reassess their spending on discretionary items, which has been weak.
• As housing prices have fallen, there has been a sharp decline in housing turnover to the lowest level in 20 years. With fewer people moving homes, spending on furniture and household appliances has been soft.
• The drought has contributed to slower growth. In some areas, conditions have been the driest on record. Farm output in Australia has fallen for the past two years and there has been a sharp drop in farm income as farmers try cope with increased costs for feed and water.
• Over the past year, the Wage Price Index increased by just 2.3%. This is a pick-up from recent years, but the lift in wages growth has stalled recently.
• Low wages growth is one of the factors contributing to low inflation. Over the year to June, inflation was 1.6%, in both headline and underlying terms.

Continued jobs strength is somewhat surprising, given the soft economic conditions, weak retail indicators and fundamental headwinds, particularly in the construction sector. The lack of improvement in unemployment adds voice to the call for even further RBA rate cuts by the end of the year. However, the RBA may prefer to receive more data on how the stimulus to date is being received, alongside an update of their forecasts before moving rates again.

Oil shock quickly reversed

The attacks on 14 September on Saudi Arabia's oil facilities have put the oil market back in focus for investors and policy makers alike. The event was reported to have been the largest single supply disruption in the oil market for half a century, crippling half of Saudi oil production and temporarily halting production of approximately 5% of global oil production.
Surprisingly, the supply shock caused by the attacks had a relatively muted impact on the major equity and fixed income markets, and it remains to be seen what long-term impact, if any, the Saudi attacks will have on oil prices. At one end of the spectrum, the 1974 and 1990 oil price shocks had enormous long term consequences on inflation, interest rates and markets. This time, the response seems to have been amazingly short-lived and prices quickly reversed.

Concluding words

Your Manager is responding to the issues discussed above by adjusting portfolios and mitigating potential harm in many different ways. 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 discounts to value, should such discounts materialise over time. Our asset allocation and stock selection strategies will ensure that portfolios are well guarded against global market volatility. Furthermore, we are still finding ample opportunities to invest in high quality companies with sustainable competitive advantages – companies that we expect to grow and perform well through the economic cycle.

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 such as diversifying across asset classes, including cash (even if the return from cash is only marginal); ensuring asset allocation is fit for purpose; by focusing on high quality companies; and maintaining a focus on sustainable yield. These strategies have stood the test of time and will continue to do so in the future.

Adrian Ezquerro
Head of Investments

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Clime Fixed Interest Fund

Investment Objective

The Fund's main objective is capital preservation. In addition, we aim to generate income returns above the RBA cash rate in the form of monthly income distributions, with a target of 2% over the RBA cash rate (including franking if available). The Fund's risk objective is set at 1.5% ± 1.0%, as defined by weekly changes of the annualised standard deviation, which is substantially lower than the equity market. In order to maximize the chance of achieving these objectives, the recommended investing time frame is at least 2 years.

Investment Strategy

The Clime Fixed Interest Fund seeks to provide an income stream above the RBA cash rate by investing mainly in the over the counter (OTC) market from a range of investment grade senior and subordinated debts, high yield bonds, asset backed securities, RMBS, income notes, capital notes and other fixed income / hybrids securities with a strong capital preservation focus. The portfolio will invest in selected high-quality individual debt and hybrid securities with consistent income generation.

Performance and Volatility of Return (30/09/2019)

	Portfolio Return **	Risk^
1 month	0.30%	-
3 months	0.70%	-
FYTD	0.70%	0.41%
Since Inception	1.32%	0.59%

*Inception date: 17 April 2019

**Portfolio return is based on the change of the unit price including distributions.

^The volatility of return is based on the change in the weekly unit price. Since the Fund is less than 6 months old, it is likely that risk indicated here is only an approximation.

The Fund achieved a return of 0.70% in the September quarter and 1.32% since inception in April 2019. At present, the Fund is not yet fully invested. It was set up at a time when the interest rates were rapidly declining, creating an environment where coupons for floating rate notes were likewise reducing sharply in anticipation of further rate cuts.

As the Fund is less than 12 months old, we have estimated that the risk as defined by the annualised weekly change in the unit price is 0.4% for the September quarter and 0.6% since inception. This approximation may prove to be conservative as when the Fund is growing fast initially, there is a tendency for the unit price to be more volatile.

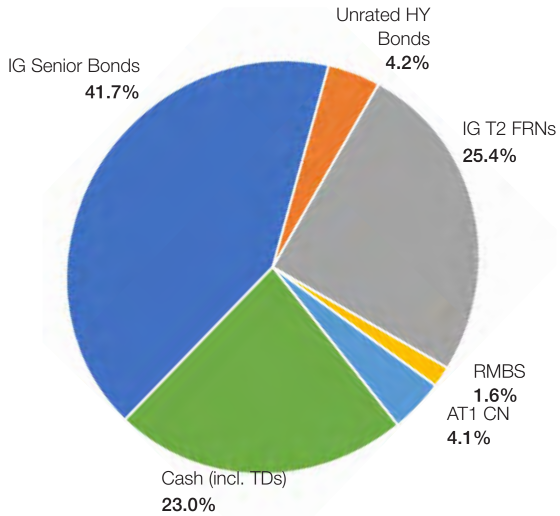
The Fund's return in the beginning of the September quarter was assisted by credit rate tightening as shown in the Australian iTraxx chart below.

Source: Bloomberg

During August, financial markets became more volatile; for example, the ASX200 fell by -2.36%. Globally, large investors tended to lighten risk assets and increase holdings of sovereign bonds (even though some US$16T of sovereign bonds globally have negative yields), and credit spreads widened somewhat. This resulted in the Fund registering a -0.04% return in the month of August. However, by September, spreads tightened and the return for September was positive. This positive return was composed of interest earned for the month and some credit tightening causing bond prices to lift slightly.

At the end of the quarter, the Fund registered a total return of 0.7% which comprised mainly of income generated from a portfolio of fixed income assets plus some modest capital gains on bonds held.

Asset Allocation



Distributions

The Fund distributes monthly on a cash basis (if any). In other words, we distribute all interest available for the month once received. For the September quarter, we distributed a total of 0.3756 cent / unit with the latest distribution of 0.1434 cent / unit for the month of September 2019.

Investment Commentary

At 30 September 2019, the Clime Fixed Interest Fund was diversified across investment grade (IG) senior and IG subordinated debt, high yield bonds, RMBS and AT1 Capital Notes / Hybrids. We have yet to invest in income notes or asset back securities. The highest portion of the investment portfolio is in investment grade FRNs at about 70%. This is core to our investment strategy as this will provide the capital preservation / price stability required by the Fund while earning interest above that of the cash rate. The objective of this earned interest is to provide for the steady and regular monthly income distributions.

During the quarter, we invested mainly through primary issuance from a range of investment grade senior FRNs and subordinated FRNs, unrated high yield corporate bonds, RMBS and AT1 CN / hybrids. Although we invested in AT1 CN / hybrids, the bulk of these purchases were tilted towards the credit rated / investment grade debt securities.

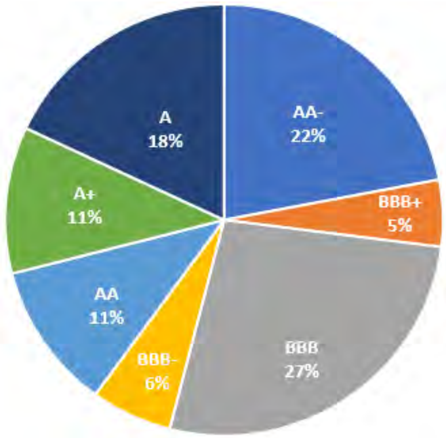
In anticipation of rates dropping further, all primary bond issuance during the September quarter were in high demand to various degrees and closed well over-subscribed.

During the quarter, we bought OTC investment grade Tier 2 FRN subordinated debts in the secondary market. We took advantage of weakness when APRA announced the methodology for the total loss absorption capacity (TLAC) with respect to financial institutions' capital ratios. This created an artificially large supply of these Tier 2 subordinated debts, causing a momentary widening of spreads of similar ranked debts. However, as rates continued to come down over the quarter, demand for any investment grade paper caused margins to subsequently tighten back somewhat.

We kept the average duration of each of the asset class buckets (senior, subordinated, unrated et. al.) short, i.e. around 3.5 to 5 years, in order to minimise credit duration risk. This is shown in the table below. As most of these debt securities are FRNs, we have not taken much interest rate risk. That said, in an environment where interest rates are being lowered, we are comfortable taking some interest rate risk and will invest in mid-term fixed rate bonds should attractive ones become available. Furthermore, supported by the very low rate environment, we may favour an increase in duration to capture a better yield provided we are comfortable with the credit and underlying business.

Asset Type	Averag Duration (years)
IG Senior bonds	4.1
IG Tier 2 FRNs	3.7
Unrated HY bonds	2.8
RMBS	2.0
AT1 Capital Notes	3.9

Figures below show the breakdown of the credit rating of the IG senior debt. As seen, more than two third of these senior debts are in the high investment rated papers (BBB+ or higher). We further note that all the investment grade Tier 2 subordinated FRNs are rated BBB or equivalent and in some cases higher.



Since the Fund was set up, we have been risk averse as risk appears to have ratcheted up. Thus, capital preservation has been a primary focus. We believe this is a prudent approach for a new fund given that the current expansion cycle has been very extended and risk appears to be increasing for a slowdown. We intend to maintain a cautious standing in the current environment, sticking predominantly with high credit papers.

Outlook

We see geopolitical risk increasing, and slower growth with muted inflation in the mid-term. The bond market is clearly signalling expectations of subdued economic growth and low inflation for the foreseeable future. If low risk and capital preservation are the main objectives, we reiterate that investors should lower their expectations of high returns over the mid-term.

The RBA cut the cash rate twice (from 1.50% to 1.00%) in the September quarter, and cut once again on 1 October 2019 to a historical low of 0.75%. It has signalled that further cuts to 0.50% are possible. Globally, we have seen central banks turning dovish and signalling further stimulus / cuts in the future. The US Federal Reserve cut twice in the September quarter (to 2.0%) while the European Central Bank eased by 10 bp to -0.50%. In addition, the ECB resumed bond purchases (QE) starting in November 2019 at €20B / per month indefinitely.

Over the quarter, the Australian 10y bond price rallied sharply from 1.32% to 1.01% (yield moves in the opposite direction to price) after touching an all-time low of 0.86% in early September 2019.

Similarly, US 10y Treasuries were at 2.01% at the beginning of the quarter and finished at 1.68%. During the quarter, the 10y and 3m US Treasury yield curve remained inverted (since March 2019), and the 10y and 2y yield curve inverted briefly but currently remains flat. Historically, this latter yield curve has been one of the better indicators of US recession 4 to 5 quarters ahead, implying the possibility of recession in 2020 or 2021.

As we write, the Australia 10y Bond is around 1.0%. In the near term, it is likely that it will trade around ± 0.30% with respect to the current level. Our view is that if bonds are sold off abruptly because of "risk off" events, credit spreads will widen and Fund performance may suffer. Compensation for the risk of investing in the Fund would be the interest earned, offsetting the decrease in bond prices. How severe any drawdown for the Fund would be depends on the magnitude of the credit spread widening, and the duration of the bonds in the portfolio.

The global economy is stuck in a low growth environment. We think this is caused by several structural factors, summarised here:

• The US-Sino trade tensions will take longer to resolve. We see further downside risks as rivalry between the top two economic powers for technology supremacy ratchets up. This will take many years to "play out";

• High debt levels amongst public and private sectors;

• Negative demographics;

• Changing climate patterns disrupting the economy;

• With ultra-low interest rates, central banks have little room to cut in the event of slower growth using conventional monetary policy. In addition to QE, more unconventional monetary policies may be deployed, increasing the risk of unintended consequences;

• The divergence between the privileged rich and the poor, eroding the fabric of society.

Investing in such an environment requires extra care. These macro themes inform our asset allocation decisions. We actively tilt our asset allocation to maximise returns while minimising risk in a dynamic manner.

Given this backdrop, is the Australian economy heading towards a major slowdown or recession? It depends on two major factors: fiscal policy and China. Over the last 3 months, the Australian economy has slowed, but is not contracting. Similarly, Chinese economic data has shown some sluggishness.

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Australian economic data appear to indicate that the tax cuts for lower income individuals and households have not predominantly been spent to boost the economy; instead most recipients have chosen to pay down debt. While this is positive for the longer term, in the short term this will be negative for economic growth. The Government has yet to initiate any major infrastructure spending as they opt instead to protect the surplus and Australia's credit rating.

The RBA under Governor Philip Lowe is increasingly being forced to consider unconventional monetary policies (like QE) to meet its inflation and unemployment targets, similar to the US Fed, and the European, UK and Japanese central banks. In reality, we have already had a preview of this over the past 6 months when bank term deposits rates dropped sharply as banks anticipated further rate cuts.

For the Fund, as we see risk increasing, we will focus on capital preservation as the first priority while generating income higher than the RBA cash rate.

Vincent Chin
Portfolio Manager

Snapshot

Portfolio Return (Month)	Portfolio Return (3-Month)	Recent Distribution	Fund Size
0.3%	0.7%	0.143428 (cents per unit)	$11.0m

Performance and Volatility of Return (30/09/19)

	1 month	3 months	6 months	1 year	2 years	3 years	Inception
Portfolio Return^	0.3%	0.7%	-	-	-	-	1.3%

^Portfolio return is based on the change of the unit price including distributions but excluding franking credits.
*Inception: Wholesale Units: 17 April 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.

Distributions

Period Ended	Wholesale Units (cents per unit)
30 September 2019	0.143428
31 August 2019	0.151699
31 July 2019	0.008045
30 June 2019	-
31 May 2019	0.027670