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Integrity Transparency Conviction

Clime International Fund Quarterly Investment Report June 2019

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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 sharemarket 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.

Market Commentary

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 sharemarket 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.

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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Portfolio Commentary

Investors have been enjoying relatively composed equity market conditions as well as decent returns on bonds, which is unusual when equities are also performing well. This has led to a positive 2019 so far, and portfolios continue to benefit from our focus on quality businesses.

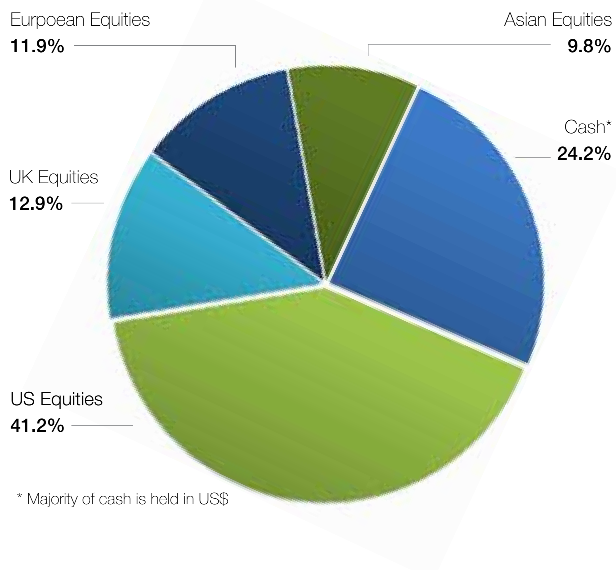
At the same time however, there are signs of a slowing global economy. Several key nations including Germany, the UK, Canada, South Korea, China and Japan are predicting weaker economic conditions and the US economy is undoubtedly moderating, with growth looking set to slow from 4% to 1.5% over the next 12 months. It's not all doom and gloom though. Growth can be driven by productivity improvements and population growth and can also be supported by low borrowing costs (interest rates) for both businesses and governments. The economic conditions to support this remain in place, for now.

The US Federal Reserve (Fed) looks set to keep interest rates low, but with very low unemployment this could further increase wage growth, and therefore inflation. At the same time, the Fed has changed the framework it uses to set monetary policy. Instead of pre-empting inflation by increasing interest rates, it will now act only at the point at which inflation visibly manifests itself. This increases the possibility of it rising above 2%, and possibly well beyond that.

The Fed is eager to keep interest rates low to avoid recession, and they have good reason to be concerned. Firstly, investors are getting a better return on short-term debt (bonds) than on long-term debt of the same credit quality, which has historically been a predictor of recession. Also, the US has been riding high on tax and capex incentives, but these inducements will soon run their course. Job creation is also likely to slow now that the unemployment rate is so low, which will squeeze corporate margins as businesses compete for talent.

With regards to equities, the recovery we've experienced year-to-date has unwound much of the opportunity we saw at the end of last year and this has reduced future return prospects. Earnings growth is critical for equities to deliver acceptable returns. If this stagnates, then this asset class will struggle. Corporate profit margins remain high, due to low historical wage growth, lower tax rates and the demand boost in the US from fiscal stimulus measures. The risk remains that current earnings represent a cyclical peak, which investors should not extrapolate in perpetuity.

Asset Allocation



* Majority of cash is held in US$

Top 5 Holdings

Stock	Ticker	Weight
Microsoft Corporation	MSFT US	4.7%
Roche Holding AG-Genusschein	ROG SW	4.3%
Allergan PLC	AGN US	4.2%
Medtronic PLC	MDT US	4.2%
Bayer AG	BAYN GY	4.1%

Performance (30/06/19)

	1 month	3 months	6 months	1 year	2 years*	3 years*	Inception*
Wholesale (AUD Portfolio Return)	4.6%	4.0%	10.9%	11.1%	10.4%	10.2%	9.3%
Retail (AUD Portfolio Return)	4.6%	4.0%	10.8%	10.5%	10.0%	9.9%	7.2%
Benchmark^	0.8%	2.4%	4.8%	10.0%	10.0%	10.0%	10.0%

Inception: Wholesale Units: 4 March 2014. Retail Units: 11 March 2015.

*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.

^Benchmark is 10% P.A

Positions Added

Bought SPDR Gold Trust Shares

We invested in a gold exchange traded fund as a substitute for our dollar cash position, as the dollar may weaken from elevated levels as the US FED starts an interest rate easing cycle by September.

Added to Bayer

Our assessment is that at current share prices shareholders are able to invest in Bayer at a very attractive valuation based on a normalised free cash flow multiple. We believe Bayer has a strong, but cyclical crop science business as well as a competitive healthcare segment which creates good economic moats.

These two core divisions enable the group to exhibit steady cash flows over time. The animal healthcare division is being sold which should bring relief to some of the group's relatively high gearing.

Litigation concerns against Bayer's glyphosate business has caused a capitulation in the share price with recent court cases going against the company. The ultimate outcome of the punitive damages that Bayer could suffer should be much less than the implied US$ 30bn currently discounted by the market. This creates a margin of safety for us as shareholders at current share price levels.

Added to Samsung

Samsung could be a winner should the US Chinese trade war escalate. Trade war escalation in any form could potentially hurt global memory demand in the short-term but this would be outweighed by Samsung's potential to gain smartphone market share, plus further share gains in memory, display, networking equipment and other components.

Given that Samsung is attractively priced we added to our position this month as conservative gains in the company's market shares could easily lead a 20% increase in earnings estimates over the next eighteen months when the stock is only trading on 9 times earnings today.

Added to Medtronic

We added to our position in Medtronic. The final year results to the end of April reassured us that Medtronic can execute on its growth strategy over the next few years. Following the results and the release of financial year 2020 guidance we forecast a compound annual growth rate of more than 5% over the next 3 years for revenue and close to double digit annual earnings per share growth over the next 3 years. With Medtronic trading at a deep discount to some of its faster growing competitors and with more than 10% upside to our intrinsic value we remain long term investors in this stable growth company.

Added to Tencent

Position added to on weakness.

Added to Fresenius Medical Care

Position added to on weakness.

Positions Sold

Exited Proshares Trust Short S&P 500

As the fund moves to a global equity benchmark, we have exited our position in an exchange traded fund which we kept for risk control purposes.

Thank you for your ongoing support.

Pieter Fourie
Portfolio Manager