Morphic
Asset Management

HALF YEAR REPORT

July - December

2018

Global Responsible Investors

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MORPHIC ASSET MANAGEMENT TEAM

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Lucina Martin, Kelsey Bentley, Kevin Zheng, Eva Trabaud

MESSAGE FROM THE MANAGING DIRECTOR

Jack Lowenstein

Managing Director

Dear Investor,

The second half of 2018 was tough for most investors, whether they specialized in local or global shares, bonds, or even property. We were no exception. Returns in the Morphic Global Opportunities Fund (MGOF) and the Morphic Ethical Equities Fund (ASX: MEC) portfolios of negative 7.7% and negative 6.6% respectively over the half were disappointing in absolute terms and also relative to our global equities benchmark which was down 4.5%.

We take note of just two consolations. Firstly, our investors still did better than the Australian market, which fell 8.8% in the half. Secondly, we had a good turnaround in the last quarter of the year, when we beat the benchmark by 0.5% for MGOF and by 1.5% for MEC.

The major difference in these returns came from MEC's short position in sectors that fail our ethical screens including tobacco. Sceptics of ethical investing love to note the horribly good returns tobacco stocks have offered for many years. In the ten years to mid-2016, the compound annual total returns from Altria, the world's largest cigarette firm were 16.5% higher than global markets as a whole. However, since mid-2016, Altria has underperformed by 16% a year, even allowing for dividends.

Tobacco stocks, with their strong non-cyclical cash flow generation and high dividends are the ultimate "bond-like" equity. However, the "top" in tobacco stocks relative to world markets was around the time investors decided the three-decade long bond rally was over.

New technologies like vaping are emerging where traditional cigarette companies have no edge and must spend heavily on R&D in both product and distribution.

Regulatory changes are also afoot posing new threats to businesses that have become somewhat fat, lazy, and over indebted. In the US, regulators want cuts in the cigarette nicotine content to below an addictive level, tilts in the competitive landscape to vaping, and a total ban on menthol cigarettes.

On the team front, Lucina Martin is now an analyst, following her graduation from the University of Sydney with a B.Sc and a B.Comm. Kevin Zheng and Kelsey Bentley who previous went through our intern program have joined us as associate analysts. We also congratulate analyst Claudia Kwan who gave birth to a baby boy in December.

We are pleased to see more and more of you at our bi-annual national roadshows. Our next trip around Australia will be in May, but in the meantime do please avail yourself of the many reports and updates we post on our website and through social media.

Kind regards,

Jack Lowenstein

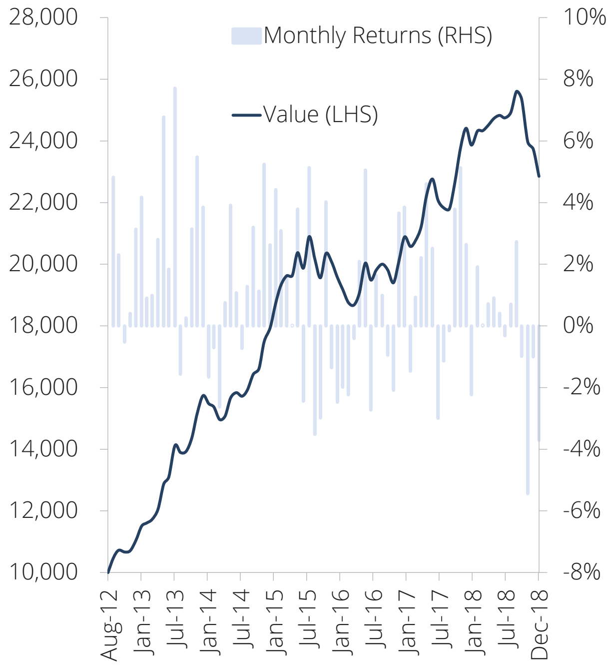
MORPHIC GLOBAL OPPORTUNITIES FUND UPDATE

CERTIFIED BY RIAA

INVESTMENT RETURNS[1]

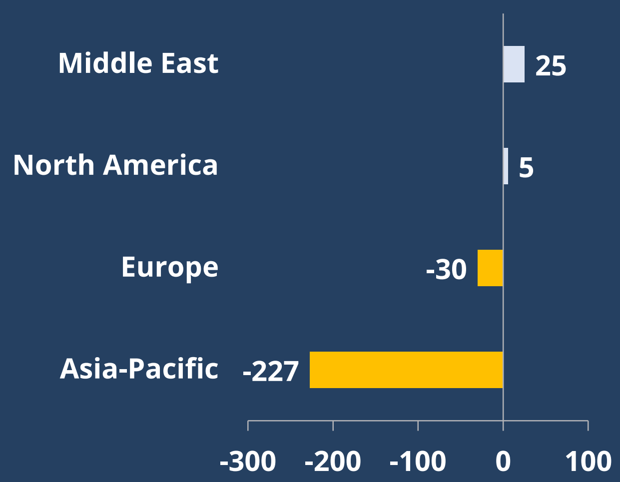
	MGOF	Index[2]
3 Months	-9.9%	-10.3%
6 Months	-7.7%	-4.5%
1 Year	-4.2%	0.6%
3 Years p.a.	5.3%	7.8%
ITD p.a.	13.7%	15.0%

PERFORMANCE OF AUD $10,000



Past performance is not an indication of future performance.

6-MONTH EQUITY ALPHA BY REGION



TOP ALPHA CONTRIBUTORS OVER THE LAST SIX MONTHS[3]

China Everbright Intl	81 bps
Service Corp	76 bps
China Water Affairs Group	40 bps

TOP ALPHA DETRACTORS OVER THE LAST SIX MONTHS[3]

Open House	-122 bps
Indian Bank	-82 bps
Axos Financial	-61 bps

[1] As at December 2018; [2] The Index is the MSCI All Countries World Daily Total Return Net Index (Bloomberg code NDUEACWF) in AUD;
[3] Attribution; relative returns against the Index excluding the effect of hedges. Past performance is not indicative of future performance.

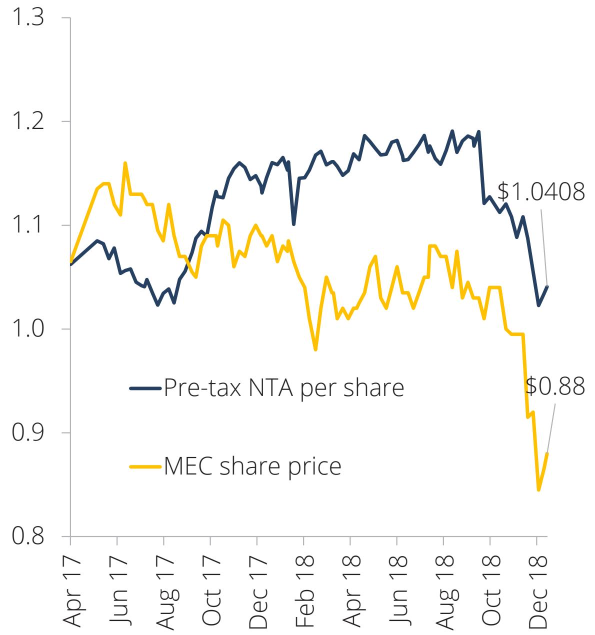
MORPHIC ETHICAL EQUITIES FUND UPDATE

CERTIFIED RESPONSIBLE INVESTMENT®
CERTIFIED BY RIAA

INVESTMENT RETURNS[1]

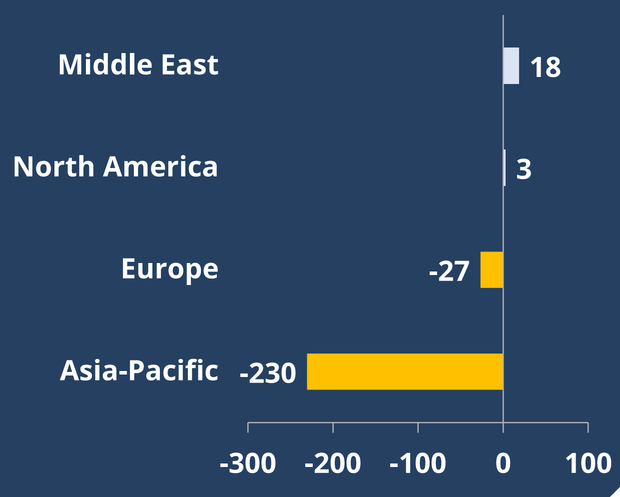
	MEC	Index[2]
3 Months	-8.8%	-10.3%
6 Months	-6.6%	-4.5%
1 year	-3.4%	0.6%
ITD p.a.	2.1%	5.8%

MEC SHARE PRICE VS NTA[3]



Past performance is not an indication of future performance.

6-MONTH EQUITY ALPHA BY REGION



TOP THREE CONTRIBUTORS OVER THE LAST SIX MONTHS[4]

- **China Everbright Intl** 80 bps
- **Service Corp** 66 bps
- **Power Grid** 25 bps

TOP THREE DETRACTORS OVER THE LAST SIX MONTHS[4]

- **Open House** -118 bps
- **Indian Bank** -82 bps
- **Axos Financial** -47 bps

[1] As at December 2018; performance is net of investment management fees, before company admin costs and taxes; [2] The Index is the MSCI All Countries World Daily Total Return Net Index (Bloomberg code NDUEACWF) in AUD; [3] Net Tangible Asset Value before tax, in AUD, between May 2017 and December 2018; the figures are unaudited; [4] Attribution; relative returns against the Index excluding the effect of hedges. Past performance is not indicative of future performance.

REFLECTIONS ON THE HALF

"What makes a decision great is not that it has a great outcome. A great decision is the result of a good process, and that process must include an attempt to accurately represent our own state of knowledge."

Annie Duke

2018 turned out to be the most challenging period for Morphic since we began, set against the backdrop of a market that has been challenging for all investors. How challenging? The only asset class that had a positive return in 2018 was USD cash (**Figure 1**). Investors lost money in bonds, shares, commodities and credit.

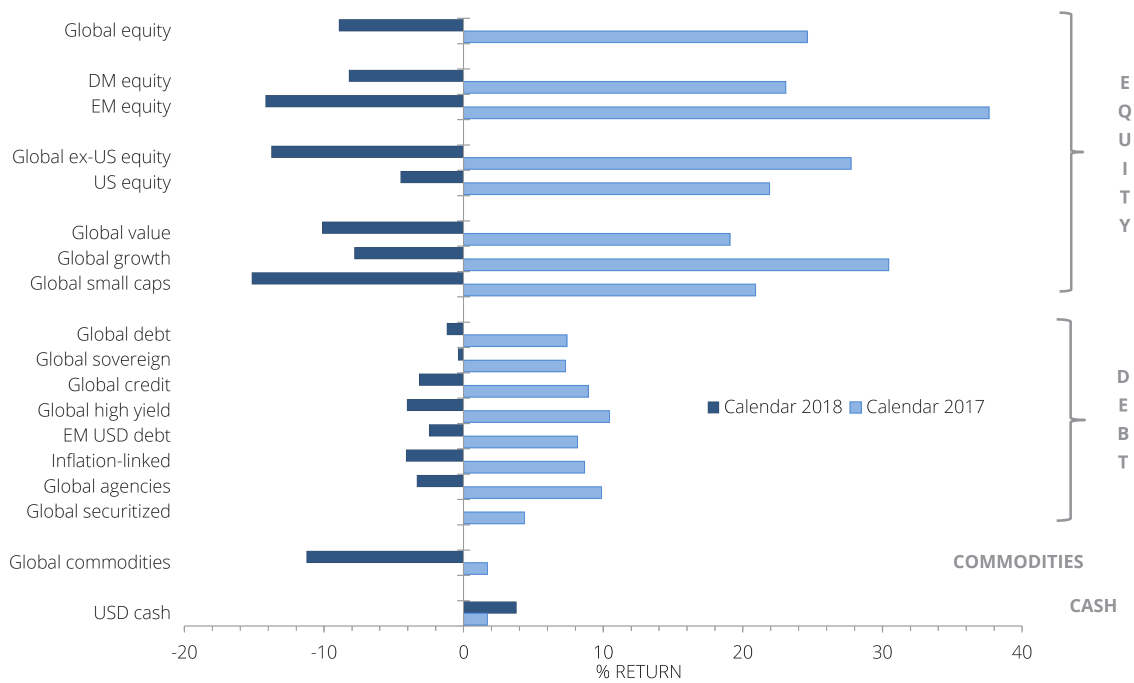
To give an idea of how rare it is for all assets to fall – one needs to look back to the mid-1970s for another year where all major asset classes lost money.

Focusing on the half just finished, markets appeared to have stabilised and began rallying from July to October, with the US market making new all-time highs in October. From that point onwards, markets reversed course to have their worst December performance since the 1930s.

Blame may be assigned to Trump and tariff wars; or a lower oil price; or generally slower growth, but a lot of those narratives do not stack up. As discussed in [our previous half year report](), it seems monetary policy was the most likely headwind for asset prices through the second half of the year.

Interestingly, real world data - as opposed to asset prices – is not fully supportive of the narrative. Short-term indicators such as business surveys are consistent with a continued expansion globally, albeit at a slower pace than originally expected in early 2018. Other leading indicators remained okay over the half. The bond market view of the world was consistent with pricing a slowdown rather than the collapse that equities priced in December.

Figure 1 – Asset class performance, total returns in USD



Source: Minack Advisors

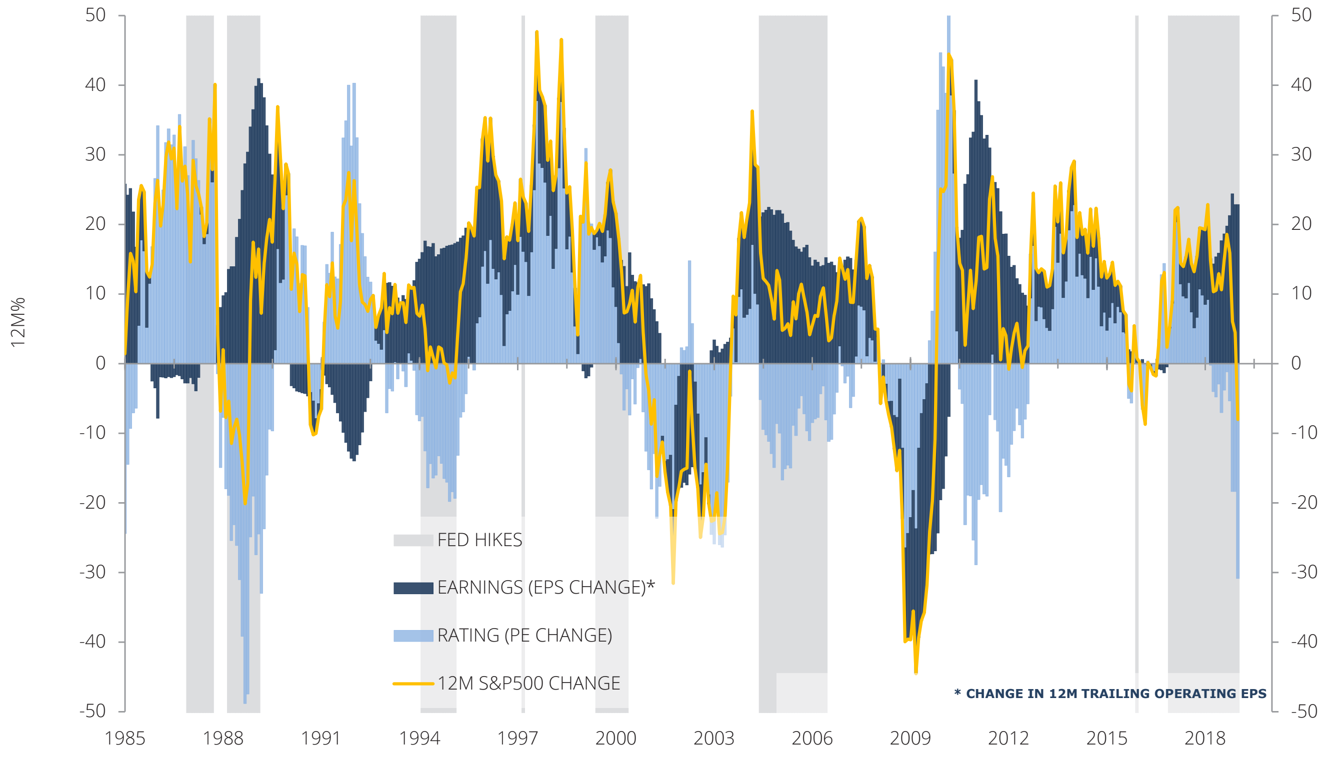
In hindsight, it seems 2018 was "payback" for 2017 exceptional returns which were better than investors would have expected given the hiking of interest rates. A chart we have commonly used (**Figure 2** below) is showing the return of the market split in "sentiment" in light blue (measured here by the P/E multiple) and earnings (dark blue). 2017 saw an unusual rise in both sentiment and earnings whereas sentiment was an unusually large drag in 2018. Another reminder that markets do few favours for free.

Against this backdrop, the Morphic Global Opportunity and Ethical Equities Funds fell 7.7% and 6.6% respectively over the half, underperforming the broader global share market by 3.1% and 2.1%. Poor stock selection from June through to September exacerbated the fall due to the regional bias to Asia. Short stocks and pairs were detractors for the half as was hedging.

So, what went wrong? Importantly, *"resulting"* whereby the outcome is used to judge the quality of the decision needs to be avoided for productive reflection. Early December, the markets got the confirmation of no further tariff wars for now; the November data was released and proved to be good. Both of these points were given as reasons to be bearish before December, but the positive outcomes seemed to be announcing a Christmas rally. Bond yields had also fallen a lot, taking the monetary pressure off. To go bearish then lacked supporting evidence. In hindsight, the rally on the reduced tariff threat was the high for the market, but we would argue that with the data presented, you would have done the same bullish trade.

In light of the weakness in multiple areas of investments, active risk was scaled back over the half. As the saying goes, when you are in a hole, the first step to getting out is to stop digging. Risk management rules are in place to mitigate deepening losses, this involved reducing the sizing of positions in both the long ideas and the pairs. The aim being to readjust and recalibrate our expectations to focus efforts on where we are having success before rescaling risk back into the portfolio.

Figure 2 – US stock market returns split into change in P/E & earnings



Source: Minack Advisors

That said, some positions had strong performances over the half. The largest positive contributor over the half was a success story in risk mitigation. We have previously written about **China Everbright International (CEI)**. CEI is a leader in Waste-to-Energy (WTE) projects in China to help alleviate their growing waste issues from urbanisation. Despite consistent new project wins, the stock had performed poorly over the first half and had ultimately been stopped out. In August, the company announced a large capital raising, sending the stock down another 30%. Since then, we were able to buy back in at the low prices and participate in the upside. With a large cash balance, the business should be able to win a disproportionate amount of government contracts in the coming five-year plan to focus on this important area.

Another large contributor for the half was US-listed **Service Corp International (SCI)**. SCI is the largest listed provider of funeral services in North America. The business is a solid steady growth business, where industry consolidation is leading to higher margins for the larger players. The backdrop of market uncertainty has seen investors rotate into the stock, pushing its P/E multiple to valuation levels which are nearing our fair value. As such we reduced our position over the half.

The largest detractor over the half was our combined position in Japanese Builders **Open House (3288 JP)** and **Iida Group (3291 JP)**. Our thesis has been that the sell-side has consistently underestimated the length of the housing cycle in Japan, coupled with an over-estimation of Iida Group's ability to monetise cost savings from its merger. Over the half, all stocks fell in the sector, but Open House was heavily de-rated, falling from a P/E of 10x to 6x and the stock dropped 40% despite rising earnings guidance. This fall stopped out both the long leg and the short leg. The stocks are on a watch list to revisit if we gain more evidence the fears are overdone.

India in general and specifically **Indian Bank (INBK IN)** and **IndusInd Bank (IIB IN)** were another large combined detractor. India has been in the grip of concerns about the failure of non-bank lender IL&FS and a feared drying up of capital to non-bank lenders. All Indian financials suffered over the half as a result of fears the Banks would be unable to recover the loans lent. IIB, which up to late 2018 had a stellar reputation for credit quality was marked down on fears IL&FS exposure marked a deterioration in lending discipline. Both stocks were stopped out.

We finish the half year review with a look at some newer additions to the portfolio. Both Funds have a short position in **Qantas Airways**. Having covered airlines for many years, we are not subscribers to the view these are businesses to hold for the long-term. With the stock going from $1 to nearly $7, most of the good news is already priced in. Into a backdrop of growth fears globally, with more pressure on carbon emissions, we feel risks are to the downside.

We also revisited another pair we know well, **Panalpina (PWTN SW)** and short **Kuehne + Nagel (KNIN SW)**. This time, we are long PWTN, whereas we were short before. Governance is a key leg of ESG analysis and the potential reform on PWTN from a sub-par governance structure with the departure of Chairman Peter Ulber, opens the door for the company to be taken over after years of botched IT implementation and sub-standard returns for shareholders. This is consistent with the Morphic ESG approach that *"improving is better than best"*. It is an understatement to say that there is room for improvement here.

WE INVEST IN COMPANIES THAT MAKE A DIFFERENCE

POWER GRID

'FASTEST GROWING ELECTRIC UTILITY IN ASIA' FOR FIFTH SUCCESSIVE YEAR

85%

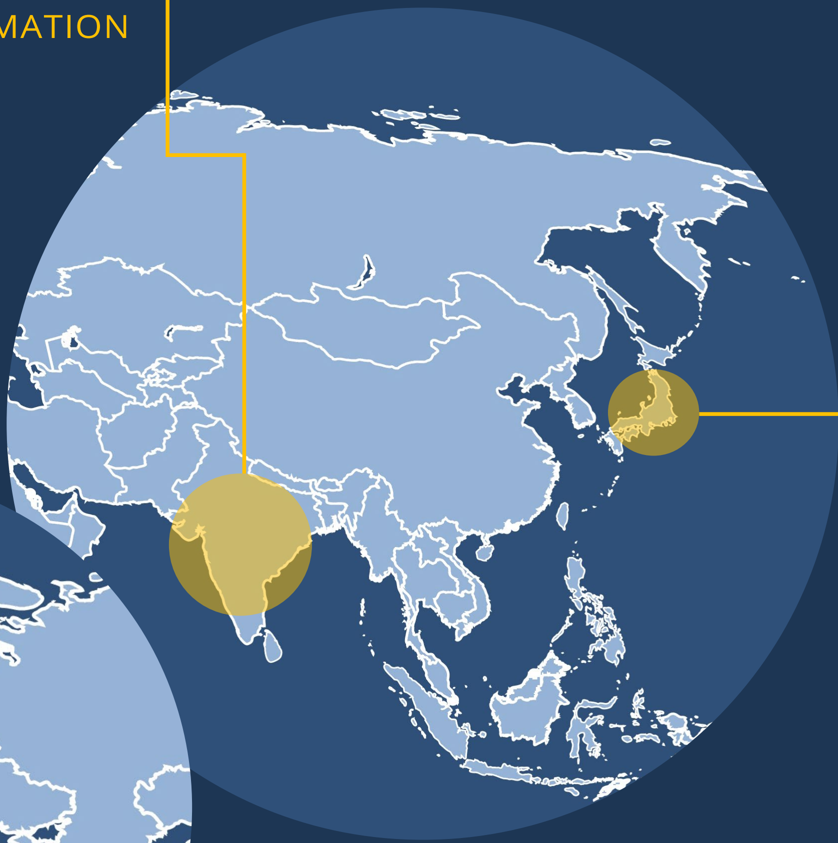
OF INTER-STATE POWER TRANSFER CAPACITY OF THE NATIONAL GRID

KION GROUP

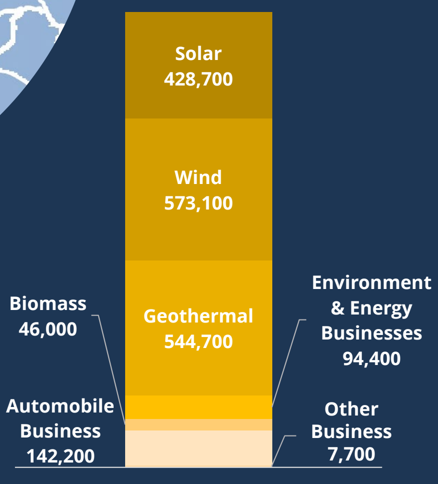
GLOBAL LEADER IN ELECTRIFICATION & AUTOMATION OF WAREHOUSES

+28%

MANUFACTURING WASTE RECOVERY IN 2017



Contributions to CO_2 emissions reductions *FY 2018, in t-CO_2*



LEAD INVESTOR IN RENEWABLE ENERGY PROJECTS

ORIX CORP

RISK MANAGEMENT

"There's no one thing that is true. They're all true."

Ernest Hemingway

The second half of 2018, like the first, was a difficult period for global markets with large gyrations. The US stock market Index, the S&P500, recorded a 20% top to bottom move and finally ended down around 8% on the half.

Three risk themes dominated over the past six months:

1. US Federal Reserve Bank on a strong hiking path;
2. Global trade tensions escalating;
3. Global growth concerns.

Of note, none of these risks were particularly new news.

We started the period holding 20% cash in anticipation of further volatility for both MGOF and MEC. However, as the old adage goes *"timing is everything"* and with the market pushing on towards new highs, cash was redeployed back into the market. This in hindsight proved premature and as the half went on, the market had a swift change of mood and re-appraisal of the aforementioned risks.

Importantly for us, while the selloff gained steam in December, two of those three risks were dissipating. The Federal Reserve was swiftly backtracking on its hike path and Trump was rumoured to be pushing for a trade deal. With still limited data support for slowing US growth, we decided that staying fully invested was the best course of action meaning we caught the swift bounce higher into the year-end.

2019 is likely to continue to be a volatile period and we will stay agile and vigilant to market developments.

SPECIAL FOCUS:
ESG RATINGS, IMPROVING OUTCOMES OR VIRTUE SIGNALLING?

"Not everything that counts can be counted, and not everything that can be counted counts."

Attributed to Albert Einstein

"If your ESG goal is to invest in mostly white, rich, Christian heritage Scandinavian countries, then this index is for you."

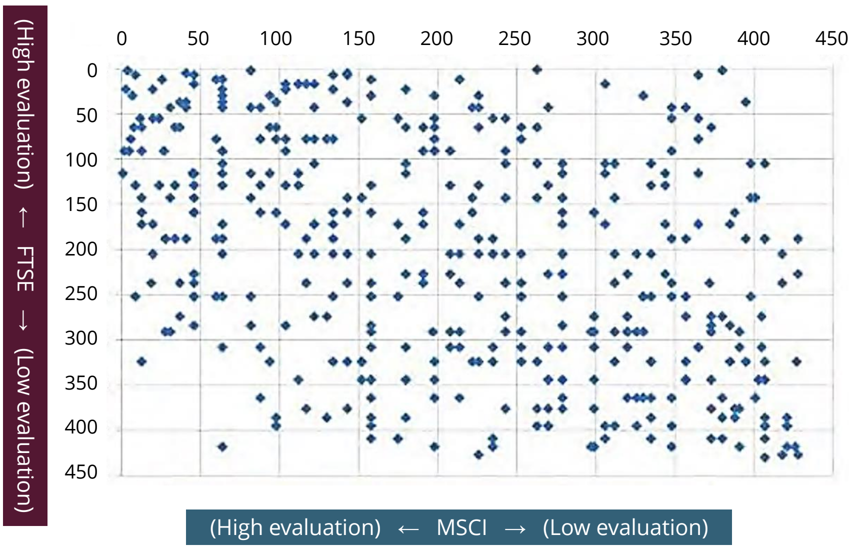
Renaissance Capital report on the problem with high ESG scores

Humans have a strong preference for quick fixes to hard problems. Look at the never shrinking world of fad diets and *"30-second workouts"* to get *"summer ready"*, when the reality is that *"habits trump goals"*: changing your daily routine slightly will lead to much larger and better lasting results.

For this reason, many investors who consider Environmental, Social and Governance (ESG) issues are increasingly looking for data providers to give stocks a rating or ranking as a quick fix to make their portfolio ESG compliant as fast as possible. Data providers such as MSCI, FTSE and Sustainalytics encourage investors to use their ratings as the standard by which portfolios should be measured, embedding themselves in this growing area of investing. Some funds are already pushing the idea that only stocks with high ESG ratings are "true ESG".

So what role, if any, should ESG ratings play inside a responsibly managed portfolio? We passionately believe that outcomes are what matter – that is, good ESG integration should result in better outcomes for both investors as well as the planet in the medium-term. We also believe any choice we make should be backed up with data.

Figure 3 – Comparison of ESG scores from FTSE and MSCI



Source: CLSA, GPIF

One big problem when looking at ESG ratings is inconsistency. What this means is when one rating agency gives a good ESG score to a company, another agency may give that same company a bad score. Without consistency, it makes it rather difficult to make objective comparisons across fund portfolios if two funds use different service providers.

Investment bank CLSA analysed the ratings for 400 stocks from two different data providers – MSCI and FTSE (**Figure 3**).

The chart plots each company as a point, with the two providers on each axis. If both providers had identical scores for each company, the blue dots should form a line running from top left to bottom right. As can easily be seen, there is nothing of the sort. Indeed, there would appear to be close to no correlation across the two providers.

Or as CLSA puts it in their report:

> *"[This report does] not discredit ESG data or the practice of scoring … it underscores the danger of relying on a simple final score for investment decisions".*

This should not be surprising to anyone who invests for a living. Taking into account dozens of factors across three distinct areas (eg, Board of Director independence; employee diversity; and carbon emissions) and creating a single number would require many assumptions and oversimplifications.

But there is a deeper, perhaps more insidious outcome, which worries us as ESG advocates. What if the idea of only investing in “high ESG” stocks becomes mandated or popularised through passive ETFs that slavishly follow ESG indices that contain the “best-in-class”?

Then global capital allocations will flow to some lucky few, lowering their cost of capital, whilst raising it for others.

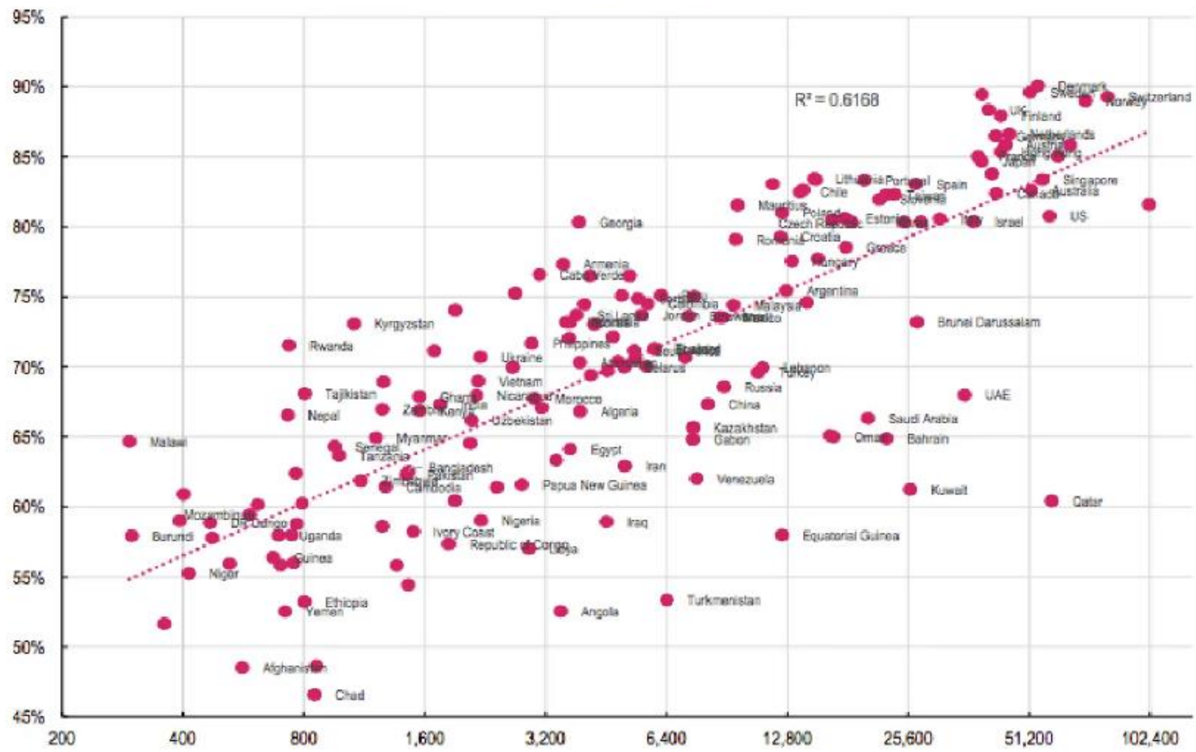
Another study conducted by Renaissance Capital looked at the characteristics of ESG scores by country of listing and then plotted them against the GDP of that country (**Figure 4**). Unlike the first chart, here there is a relationship. Unsurprisingly, rich countries have better ESG scores.

As Renaissance notes, emerging and frontier markets are:

> *“(almost by definition) less well governed, more corrupt and increasingly polluted... Sending children to school, avoiding slavery, giving women the vote and therefore having a democracy, low corruption and clean water are all ESG goals that the UK and the US (among others) only endorsed as they got rich, not before they started industrialising.”*

If outcomes are what you as an investor care about – those outcomes being lower child mortality, more electrification etc - then even if Emerging Markets have lower absolute ESG ratings, directing capital to them will allow for the highest overall rate of improvement for the global economy.

Figure 4 – ESG scores for 167 countries compared with GDP per capita ($), 2016



Source: Renaissance Capital, UN, World Bank, IMF

This conclusion challenges the narrative espoused by amongst others Alliance Bernstein, that investors should question their managers on their choices to invest in low-rated ESG companies. The opposite appears to be true: investors should also challenge their managers as to why they have invested only in highly rated ESG stocks!

Nuance is needed here as well and investing in low-rated stocks in Australia for the sake of it is unlikely to increase either investor returns (low rankings inside countries have been shown to underperform) or improve the world. But it reminds one of why context matters.

This raises the question of whether an ESG framework will in the future impede investment from regions that are deemed "poor ESG candidates". If poor countries can develop through green energy alone, there is not necessarily a conflict. If they cannot, they will end up being starved of capital, that starvation being caused by the rating houses in their effort to promote better ESG standards!

It would be nothing short of a tragedy if this were to occur: poor countries being told, essentially, they need to be poor to make western investors feel good about themselves.

BROADER ISSUES FOR ESG INVESTMENT PRODUCTS

The flaws in ESG ratings unfortunately flow on to a number of ESG products offered in Australia and internationally.

We were shocked recently to discover that one heavily promoted Exchange Traded Fund (ETF) based on ESG ratings still includes as its second largest holding Johnson & Johnson (J&J). This is despite the fact that J&J is facing a barrage of litigation relating to asbestos contamination in its famous Baby Powder product and allegations of a longstanding management cover-up.

The problems are particularly apparent in ETFs, yet they also apply to several funds that are marketed in Australia as actively managed ethical products. They have large universes of stocks and appear to focus the bulk of investment analysis on either using screens to eliminate companies with poor ESG scores or, focus on stocks with high ESG scores.

ETFs can generally have a valuable place in investors' portfolios, but when it comes to ESG products investors should look beyond the marketing wrapper, and check closely on the actual ingredients.

In practice, to avoid genuinely bad companies whose fall from grace can cause damage to investors' wealth, funds that focus on case by case research for more concentrated portfolios will give better outcomes.

IMPLICATIONS FOR MORPHIC

How does Morphic use this data? We have been a consistent advocate of the *"improving is better than best"* ESG model for investing. The Funds have a large allocation of Emerging Markets and we have invested in stocks in Emerging Markets that may have lower ratings, but which are working to improve outcomes in those countries.

We engage with companies with poor governance, looking to publicise both the improving examples and call out those with poor practices who seek to do nothing. We may have exposure to certain carbon intensive industries (such as cement) where there is a materially positive impact to that society and its economic growth in combination with management with best-in-class (locally) environmental understanding.

Because, most of all, we believe the best outcomes for the world occur when capitalism is used to improve lives, not in telling poor people to stay poor.

OUTLOOK

"And he can see no reason
'Cause there are no reasons
What reason do you need to be sure…
Tell me why I don't like Mondays, Tell me why I don't like Mondays"

I Don't Like Mondays, Boomtown Rats

To look forward to this half, we need to look backwards.

Annie Duke's *"Thinking in Bets"*[1] is one of the best books of 2018. Annie was a psychology student who went on to become a world series poker champion and this is her book on how poker can help improve decision making in the real world. One of the key sections is on *"resulting"* – that being a tendency to judge decisions by their results rather than the process behind the decision. When was the last time you had a bad result yet said it was a good decision?

We were consistently bullish through 2017 and mostly bullish through 2018. This decision was correct in 2017, however in 2018 it was not. This matters on two levels: firstly, for judging our decision-making process but also for what one should expect in 2019.

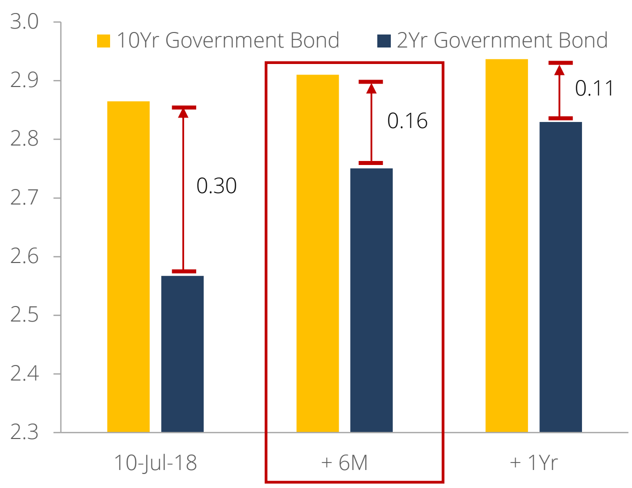
Our half year report from July 2018 outlined the "bear" case with three points that should work if there were a bearish outcome.

Firstly, the yield curve: our view was that it would continue to flatten and not invert and therefore not signal an imminent recession. The chart on page 15 of that report (also shown in **Figure 5**) had the market implied spread at 16bps in early 2019. Today it is… 16bps. Major US economic data such as job creation didn't slow over the last half, and the shape of the curve traded with that data.

Secondly - *"politics now matter"*. Yet tariff risk fell, not rose: in December we saw Trump and Xi meet and agree to a tariff cease fire and negotiation. If politics did not matter, a de-escalation should be good. Thirdly, *"the USA is not the world"*. This turned out to be the reverse to the bear argument: the US was the worst performing region in December. This is not what one expects in large drawdowns.

Put together, it is hard to escape the conclusion that ex-post reasoning on the year-end falls lack ex-ante justifications. Or more simply *"I don't like Mondays"*[2].

Figure 5 – Market implied Future US Bond Yields as at 10 July 2018



Source: Bloomberg, Team Analysis

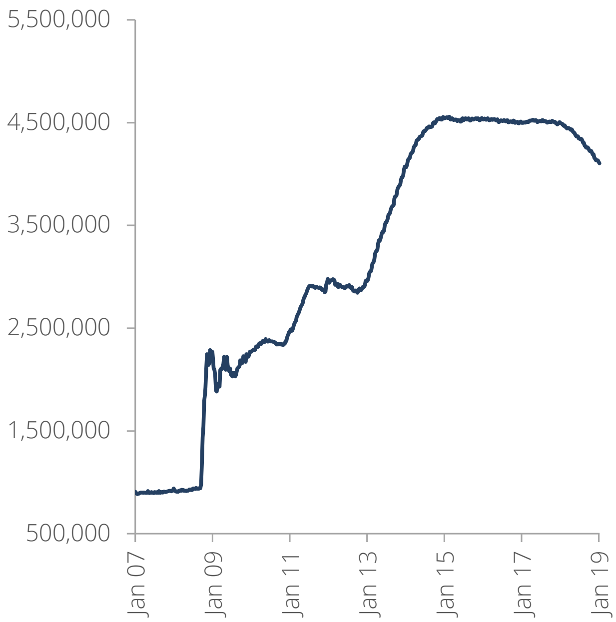
[1] We'd highly recommend the book to those looking to improve both their investing and more general decision making in their lives.

[2] We all seek narratives to explain things. Often there is no reason, as Bob Geldof wrote in "I don't like Mondays".

Therefore, at this stage, we would conclude that the decision-making process has been sound, but assign a lower confidence to our own forecasts.

What did we learn about other concerns? Are there things we missed?

Figure 6 – US Federal Reserve Balance Sheet (FARBFSRF)



Source: Bloomberg, Team Analysis

We would say the shrinking balance sheet of the Federal Reserve is a concern to a lot of participants (**Figure 6**). Rightly or wrongly, the Federal Reserve themselves have not been overly concerned , but they have come to accept the market is concerned. The shrinking of excess reserves in the US has been accompanied by an acceleration in bank lending which the Federal Reserve sees as a good thing. The large financing needs of the Trump Government seems to be the more likely liquidity candidate.

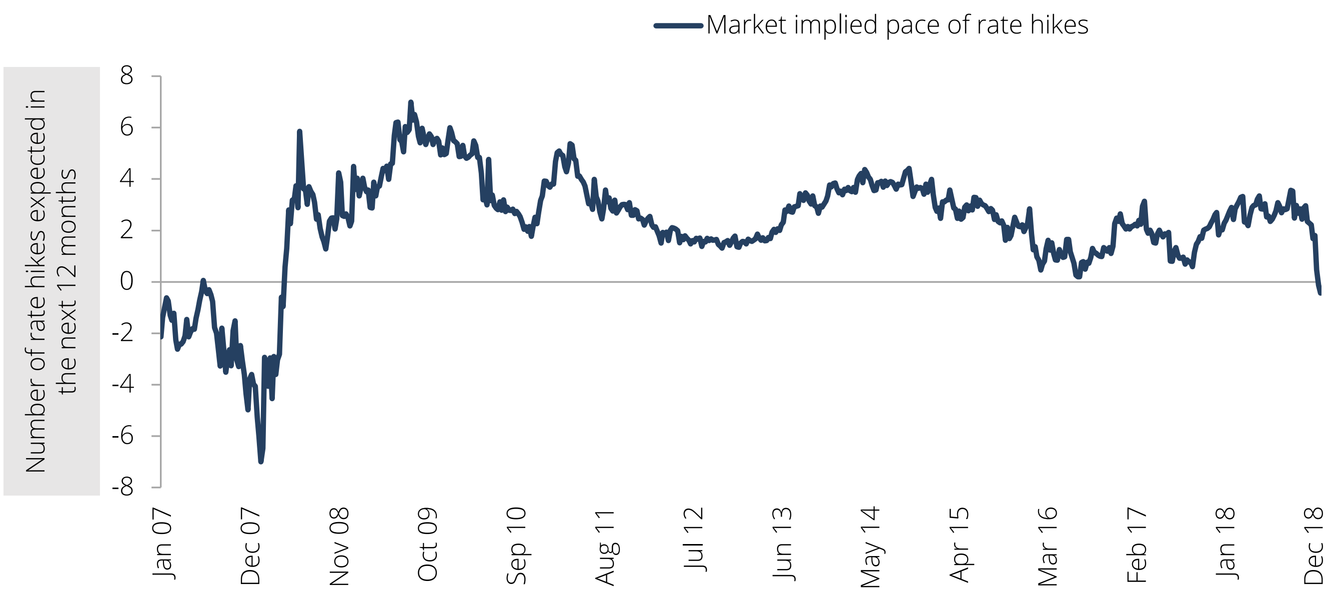
And why should the market rally over the next six months?

There are three axes to making money: fundamentals/valuations, positioning and sentiment.

Firstly, fundamentals: if the argument was that higher rates were a reason to be bearish, the good news is rates are much lower than where they were in October and the market expects no more hikes in 2019 (**Figure 7**).

On the other side, with oil prices now 30% lower, consumers will benefit from lower interest rates, lower gasoline prices and for the first time in this cycle, accelerating wages with wage growth in the USA now over 3%.

Figure 7 – Morgan Stanley's Market Implied Pace of Rate Hikes (MSPOKE Index)



Source: Bloomberg, Team Analysis

Whilst this may be pressuring margins for some companies, it is difficult to see how this is "recession like" and it is recessions that really kill equity returns.

Using forward P/E's, valuations, whilst not rock bottom, are cheap for many of the world markets. In forward earnings (**Figure 2** in the "Reflections on the Half" section) over the last six months there are minimal downward revisions, with a P/E de-rating or "fear of the future" being the driver.

Secondly, sentiment. This refers to what investors say they "feel like". Bank of America Merrill Lynch publishes an index that measures this from 0-10 with 0 being "fear" and 10 being "greed". In December it was at 1/10 (in January it was 9/10). Sentiment is not bullish.

Thirdly there is positioning. It is one thing to say you feel worried, it is another to change your portfolio. Morgan Stanley data shows that Hedge Funds started 2019 the least invested in nine years; that redemptions in mutual and ETFs were substantial towards the end of 2018.

Together the three axes would suggest a bullish stance remains appropriate.

So, our base case is that the first half of 2019 sees a deceleration of headline US GDP and data as the one-off effects of the Trump tax cuts disappear, offset by a stronger consumption contribution. If the market thinks this is transitory, it will "look through" when it believes the Federal Reserve is making a policy mistake and hiking.

The biggest issue that we see is several broader measures of financial conditions are tightening. Credit spreads are wider, raising funding costs for companies and potentially increasing the risks of default in the future which happens before a recession.

It is also well-known that *"monetary policy works with long and variable lag"*, so the economy will not feel the recent hikes until late 2019 as they work through the system. The US budget deficit this year is expected to expand to 4% of GDP, issuing $1.3trn of net debt, unprecedented in expansionary times.

One potential positive is if the Chinese stimulus starts to have an effect. At this stage the stimulus has been limited but could expand. The Chinese government appears to be extremely focused on not replicating the infrastructure and debt splurge of 2016. Stimulus this time is focused more on increasing personal consumption, whilst bad for Australian iron ore exporters, should be good for decreasing their trade surplus and the balance of the economy.

One of the most interesting things about the last quarters sell-off was that Emerging Markets outperformed the larger US market, consistent with what we wrote in the half year report in Juy 2018, despite not being the path we thought it would take to get there. This speaks to the three axes in alignment in this region.

The other quirk to note was the inability of the US dollar to rally in this sell-off. With the market removing rate hikes and equities bouncing, the US dollar might come under further pressure this year, though we would note the consensus view at the start of 2019.

HOSTAGES TO FORTUNE: ANTI-PREDICTIONS FOR THE FIRST HALF OF 2019

"You must always be able to predict what's next and then have the flexibility to evolve."

Marc Benioff

As usual, we finish our report with a series of "non-predictions" for things we do not think will happen between now and June 30th, 2019. First, we must reflect on the performance of our last set of "anti-forecasts" over the half that just ended.

BACK CHECK

US 10-year bond yields will NOT break above 3.50%

Hit! Emphatic win here with US bond yields finishing the year at 2.68%, well below the level most people were forecasting at the middle of the year. The curve continued to flatten, though at lower levels as the market took out future hikes.

US Equity Markets (MSCI USA) will NOT finish lower

Miss! As they say in sport "played well for 3 quarters, but unfortunately the game is 4 quarters". As recently as the end of November, this prediction was looking good. The worst December since the 1930's for the USA put an end to that. Lower yield and better EPS did nothing to save the savage de-rating.

US Investment Grade Credit will NOT go below their 2018 lows (JP Morgan Global Aggregate IG Credit Index Spread)

Hit! Higher interest rates and panic in the equity markets proved to be a toxic mix for credit spreads.

Australian shares will NOT outperform global shares

Hit! Despite global markets falling, the Australian dollar falling plus the bank heavy local index suffering from the Royal Commission fallout and housing fears led to global shares slightly outperforming Australian shares in common currency over the half.

Trumps ratings will NOT collapse

Hit! 41.8% approved of Trump (using 538 website aggregation data) at June 30th, with this number finishing at 41.5% at December 31st. Loyal supporters remain unphased about tariffs, government shutdowns and criminal investigations. Equity investors turned out to be less impressed.

A paradox: 4 out of 5 is one of our best outcomes, coupled with one of the poorest performances of the Funds. The divergence relates to the fact that as an equity firm, the second prediction is of out-sized importance and the other predictions mostly help inform that prediction.

NEW VIEWS

We conclude this report looking at our predictions of what WILL NOT happen by June 30th, 2019.

Emerging Markets will NOT underperform Developped Markets

If January 2018 was all “sweetness and light” for Emerging Markets (EM) on the belief that 2017 would carry on, by October it had turned to darkness and despair. Then something remarkable happened: the US market collapsed in December and Emerging Markets outperformed. There is a saying in the market that strong price action into weak backdrops shows you the future leader. With the Federal Reserve likely on hold, or maybe with one hike left, EM earnings revisions at lows; positioning now lighter; and valuations good if not compelling, barring an escalation of the trade wars, EM outperformance should continue.

Short-Term Interest (2-year yields) rates will NOT be lower

2019 will see a strange dichotomy – a Federal Reserve that walks back on their rate hikes, but a bond market that went too far in pricing cuts. Hence an odd outcome: economists revise down expectations of Federal Reserve hikes, yet bond yields do not fall.

US market will NOT finish below the December 2018 lows

The first half of 2019 will likely see the US equity market climbing a wall of worry. Economic data will likely continue to soften but with the Federal Reserve easing off the brakes, equity markets will likely breathe a sigh of relief and push above 2018 lows – with some wobbles along the way no doubt.

Europe will NOT outperform Japan

One has to feel a little sorry for Japanese corporates: having been hectored by Westerners for failing to run to maximise shareholder value, after improving returns, buying back shares and increasing dividends, they have been rewarded for this with… a large de-rating. At 11x forward earnings and vastly improved corporate balance sheets with somewhat improved capital management, 2019 could see the sun rise on forgotten Japan. Europe on the other hand is about to discover Brexit woes do not end at the English Channel, and is likely to face inappropriately tighter monetary policies, and continuing political stress caused by slow growth.

Australia will NOT avoid Political volatility, meaning another half of underperformance

Globally politics have become a more significant driver of market performance. Locally despite numerous Prime Ministers and changes of parties in power, Australia has largely avoided its politics having any impact on either its stock market or currency over the last decade. This year we expect to be different. The Australian Labor Party enters the year strong favorites which will mean financial markets will have to start moving to factor in potential changes to franking credits, capital gains taxes and changes to negative gearing tax rules.

GLOSSARY

Alpha
Alpha, sometimes called the 'active return' on an investment, gauges the performance of an investment against a market index or benchmark which is considered to represent the market's movement as a whole.

Bond
A bond is a fixed income investment in which an investor loans money to an entity (typically corporate or governmental) which borrows the funds for a defined period of time at a variable or fixed interest rate. Bonds are one of the three main generic asset classes, along with stocks (equities) and cash equivalents. The indebted entity (issuer) issues a bond that contractually states the interest rate that will be paid and the time at which the loaned funds (bond principal) must be returned (maturity date).

Consumer Price Index (CPI) and Core CPI
The Consumer Price Index (CPI) is a broad measure of inflation within an economy in relation to the cost of goods and services. That figure can have a significant impact on the value of a currency in relation to the currencies of other nations. The Core CPI excludes costs in the energy and food sectors, which tend to experience greater price volatility over time.

Credit Spread
A credit spread is the difference in yield between a Treasury bond and a debt security with the same maturity. To illustrate, if a 10-year Treasury bond has a yield of 2.54% while a 10-year corporate bond has a yield of 4.60%, then the corporate bond offers a spread of 206 basis points over the Treasury bond.

Dividend Yield
A financial ratio that indicates how much a company pays out in dividends each year relative to its share price. Dividend yield is represented as a percentage and can be calculated as follow:
Dividend Yield = (Annual Dividend Per Share) / (Price Per Share).

Federal Funds Rate
The Federal funds rate is the rate at which depository institutions (banks) lend reserve balances to other banks on an overnight basis and is set by the Federal Reserve. The Federal Funds rate is one of the most important interest rates in the U.S. economy since it affects monetary and financial conditions, which in turn have a bearing on critical aspects of the broad economy including employment, growth, and inflation.

Gross Domestic Product (GDP) and Real GDP
The market value of all goods and services produced within the economy in a given period of time.
Real GDP is an inflation-adjusted measure that reflects the value of all goods and services produced by an economy in a given year.

Source: CFA Institute and Investopedia

NTA
Net tangible assets are meant to represent a company's total amount of physical assets minus any liabilities within the company.

Pairs trade
A basic long–short trade in which an investor is long and short equal currency amounts of two common stocks in a single industry.

Price to Earnings Ratio (P/E)
The ratio of a company's current share price to its per-share earnings. the price-earnings ratio indicates the dollar amount an investor can expect to invest in a company in order to receive one dollar of that company's earnings. A high P/E ratio suggests that the company's share price is expensive relative to the company's profits, which usually implies that investors are expecting the company's future profits to grow quickly.

Purchasing Manager Index (PMI)
The Purchasing Managers' Index is an indicator of the economic health of the manufacturing sector. The PMI is based on five major indicators: new orders, inventory levels, production, supplier deliveries and the employment environment.

Real interest rate
A real interest rate is an interest rate that has been adjusted to remove the effects of inflation. The real interest rate is calculated as follow:
Real Interest Rate = Nominal Interest Rate - Inflation (Expected or Actual).

Sharpe Ratio
The Sharpe ratio is the average return earned in excess of the risk-free rate per unit of volatility or total risk. The Sharpe ratio has become the most widely used method for calculating risk-adjusted return. The ratio describes how much excess return you are receiving for the extra volatility that you endure for holding a riskier asset.

Short Selling or Shorting
A transaction utilised to generate a profit from the fall in price of a financial security such as shares, indices, commodities or other financial assets. Short selling is the sale of a security that is not owned by the seller or that the seller has borrowed. It may be prompted by the desire to hedge the downside risk of a long position in the same security or a related one.

US 10-year treasury yields
It refers to the return on an investment in a US government 10-year debt obligation. The 10-year U.S. Treasury bond can help gauge investor sentiment. High investor confidence means falling prices and demand for the 10-year Treasury, and therefore a higher yield, because investors are confident they can find other investments with better returns. Prices rise and its yield decreases when confidence is low as there's more demand for this safe investment.

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