



Net Tangible Assets Report

June 2019



We pass the mid-point of calendar 2019 with a sense of the dichotomy between strong bond and strong share markets, and yet, a deeply uncertain economic and geo-political environment. 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), while the Australian S&P/ASX 200 accumulation index was up 19.7%. 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 while presented with unprecedented challenges.

These include a staggering US\$12 trillion in global government bonds yielding negative interest rates, the virtual absence of inflation in many developed countries, the US economic growth cycle of almost unparalleled longevity, the US and China trying to 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.

Over the longer term, investors should also be pondering massive government and consumer debt in many parts of the world, the monopolistic challenges of Big Tech and the loss of privacy, and of course climate change, the inter-generational divide, and the unsettling rise of autocratic populism. But in this report, we will restrict our comments to a brief review of the markets, the economic milieu in the larger countries and regions, a few notable investments 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 industrialised countries is unusually low, in fact too low for most central bankers, who fear deflation. Central banks are thus under no pressure to tighten monetary policy – a fact which capital markets are celebrating.

The central bankers are sending reassuring signals that, in the case of weak economies or tensions in the financial system, they are ready and able to act. It is unlikely that the US Federal Reserve, the European Central Bank, the Bank of England, the Bank of Japan or the RBA will raise their key rates any time soon. While the yields on government bonds are artificially depressed, and 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 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 at best and yet, thanks to the central banks, financial markets are upbeat. As expanded upon below, we remain somewhat 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 19.7%. Over the same period, the Liberal-National Coalition was returned to power, commodity prices were strong with iron ore a standout, government bond yields were lower, and the official interest rate was cut by 0.25%. 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, it 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".

A highlight has been Australian listed property securities (A-REITs) where market prices moved from slight discounts to NTA to significant premiums. The rally in property security prices pre-empted the RBA cash rate cut and reflected the marked decline in bank term deposit rates. The strong performance of A-REITs is associated with the chase for yield, particularly by retail investors and savers.

Over the last 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 some offset and a pick-up in activity in the resources sector is underway. 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 US 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 to 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 disrupt their supply chains and abandon their investment plans.

Concerns over escalations in the trade dispute have given fresh impetus to rate cut expectations. The latest statements by 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.

Over the last year, the US economy has been pulling away from its western counterparts. 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,

Market Commentary

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. 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 Ratio (next 12 months) 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 trade conflict between China and the USA has waxed and waned. US sanctions against the Chinese telecommunications group Huawei have raised serious doubts in China over US willingness 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 been weak. Measures implemented so far by the government have not yet stabilised the economy. Earlier this year, the government set a GDP 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 paint a subdued 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. Overall, manufacturing conditions look particularly weak: the Eurozone manufacturing PMI is below 50 (implying contraction), and weaker still in Germany, where the PMI is 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 European countries. Germany leads the field with an unemployment rate of 3.2%, whereas Spain still has unemployment at 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 ECB has lowered 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 if required.

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. 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

Portfolio Update

The Clime Capital portfolio returned +0.9% in June, net of all fees and taxes, compared to a +3.4% return for the S&P/ASX All Ordinaries Accumulation Index.

While the portfolio generated a positive absolute return for the month, underweight positions in listed interest rate sensitive sectors as well as materials, most notably gold stocks, dampened the relative return.

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

- Australian Equity Large Cap Sub-Portfolio: Positive contributors BHP Group (+9.0%), CSL (+4.6%) & Westpac Banking Corporation (+3.4%), no material detractors.
- Australian Equity Mid Cap Sub-Portfolio: Positive contributors Credit Corp (+6.5%), Afterpay Touch (+3.8%) & Orora (+3.2%), detractors Bravura Solutions (-14.0%), Premier Investments (-12.1%) and Webjet (-8.4%).
- Australian Equity Small Cap Sub-Portfolio: Positive contributors APN Property Group (+12.4%), Jumbo Interactive (+11.9%) & Electro Optic Systems (+8.8%), no material detractors.

BHP (BHP) and Rio Tinto (RIO) further contributed to portfolio returns as iron ore prices continued to surge higher in response to supply shortfalls relative to buoyant Chinese steel production.

Credit Corp (CCP) has been able to materially increase the rate of employee hiring in the US post the first half result, with the company now on track to reach capacity of 430 people at the initial site by 30 September 2019. As a result, the medium to long term earnings outlook will be supported by the ramp up in the US business. Bravura Solutions (BVS) was impacted by a reducing probability that it will be successful in acquiring GBST Holdings, which would be an earnings accretive transaction.

APN Property Group's (APD) net tangible asset base now approximates \$125m, implying a modest valuation for the high quality asset management operation, which has Assets Under Management of around \$2.9bn. The strong performance by Electro Optic Systems (EOS) followed a positive market update in May, indicating compound revenue and earnings growth of over 45% over the next two calendar years.

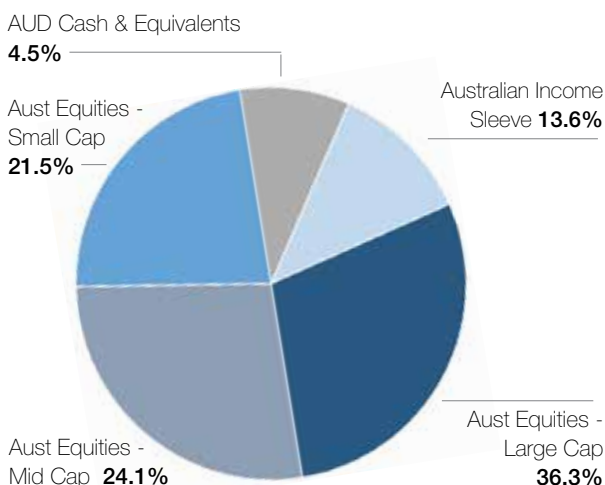
Ongoing migration of physical store sales to online channels, coupled with some large lottery draws during the month, including an \$80m Ozlotto draw, have increased expectations for a strong Jumbo Interactive (JIN) result.

| | | | |
|----------------|--------------------------------|---------------------------|---------------------------|
| NTA before Tax | Total Portfolio Including Cash | Rolling 12 Month Dividend | Historical Dividend Yield |
| \$0.97 | \$110.0m | 5.0cps | 5.2% |

Top Holdings (% of Gross Assets)

| | |
|-------------------------------------|------------|
| National Australia Bank Limited | 5.4 |
| Westpac Banking Corporation Limited | 5.3 |
| Amcort Limited | 5.3 |
| BHP Billiton Limited | 4.3 |
| Treasury Wines Estate Limited | 3.3 |
| AUD Cash | 4.5 |

Gross Asset Allocation



Net Tangible Assets (NTA)

| | June | May | April |
|----------------------|---------------------|--------|---------------------|
| NTA before tax | \$0.97 ² | \$0.96 | \$0.95 ¹ |
| NTA after tax | \$0.94 | \$0.94 | \$0.92 |
| CAM Share Price | \$0.97 | \$0.89 | \$0.88 |
| Yield Excl. Franking | 5.2% | 5.6% | 5.7% |
| Yield Incl. Franking | 7.4% | 8.0% | 8.2% |

¹ On 21 February 2019, the Board declared a fully franked dividend of 1.25 cents per share in respect of the Company's ordinary shares for the period 1 January 2019 to 31 March 2019, paid on 26 April 2019. NTA before and after tax disclosed above for April 2019 is after the effect of this dividend payment.

² On 3 June 2019, the Board declared a fully franked dividend of 1.25 cents per share in respect of the Company's ordinary shares for the period 1 April to 30 June 2019, payable on 26 July 2019. NTA before and after tax disclosed above for June 2019 is before the effect of this dividend payment.

Company Overview (\$m) (Cum Dividend)

| | |
|---------------------------------------|-----------|
| Australian Equities | \$90.15 |
| Australian Income Sleeve | \$14.94 |
| AUD Cash & Equivalents | \$4.92 |
| Total Portfolio including Cash | \$110.01 |
| Notes Payable at face value of \$0.96 | (\$21.39) |
| Net Tangible Assets | \$88.62 |