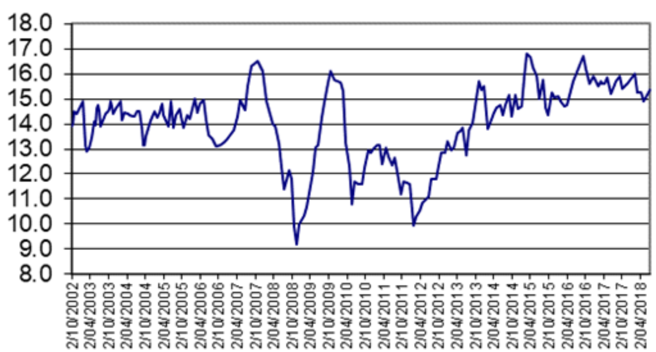
Monthly Investment Review

July 2018

Valuations

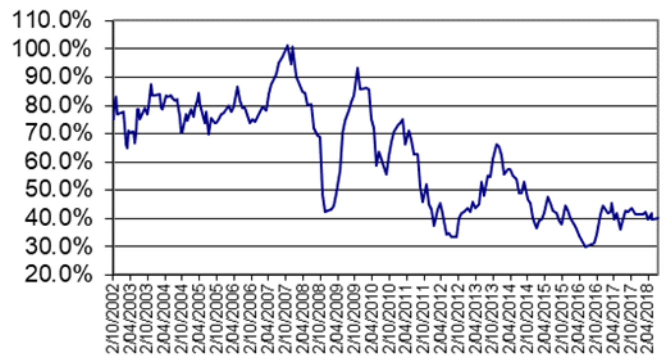
- At face value, market appears reasonably valued within historic price earnings range.
- Furthermore, compared to bond yields, which remain low, it appears very attractive.
- However, this disguises the polarisation in the market between expensive growth stocks, bond proxies and financials, resources and some industrials that appear cheaper.
- This divergence is driven by disruption impacting the outlook for many traditional companies and low interest rates.

Rolling forward PE



Source: DNR Capital

Bond yield on earnings yield

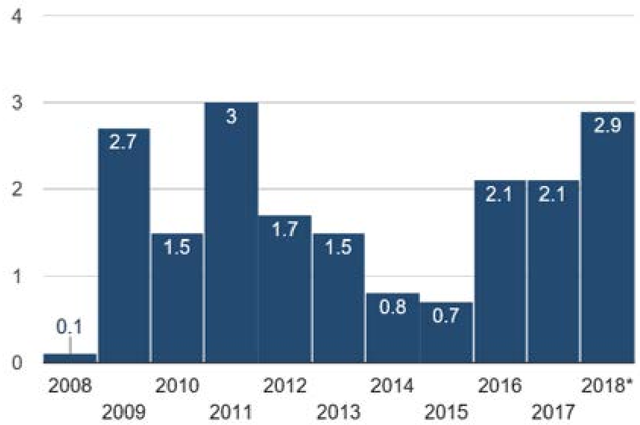


Source: DNR Capital

Inflation

- In recent years a number of factors have restricted wage growth, including: internet solutions; robotics; a high number of baby boomer retirees replaced by cheaper workers; and a significant drop in oil prices.
- In addition, the global financial crisis led to a large labour slack unaccounted for in the headline unemployment figure.
- The large excess slack outside of the labour force was a key factor in limiting wage growth, but this is now easing.
- This, along with populist policies like tariffs and tax cuts which are inflationary, is resulting in a slow but steady pickup in inflation.

United States annual inflation rates (2008 to 2018)

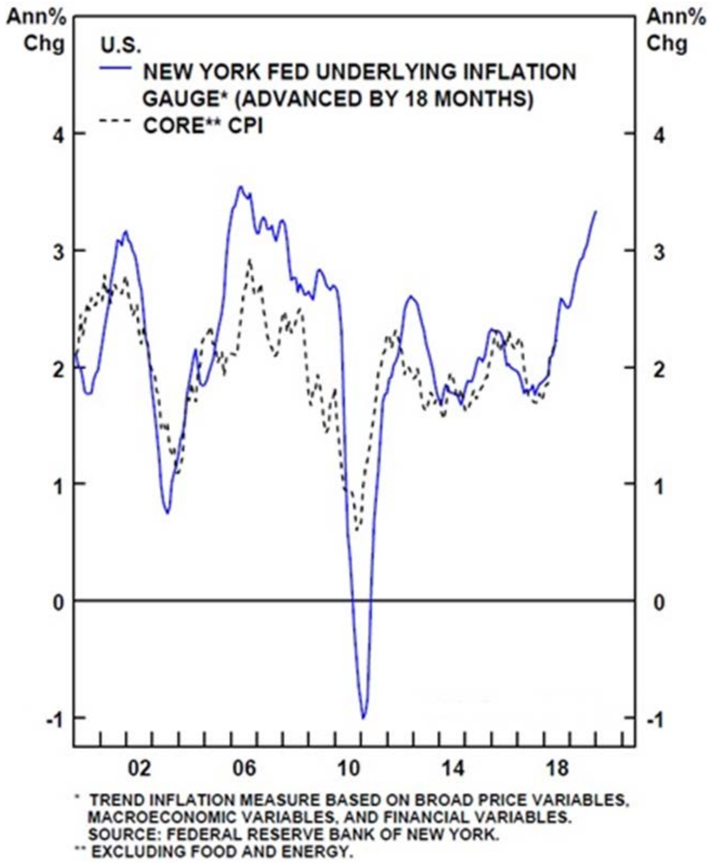


Source: BCA Research

Inflation

- Interestingly, a lead indicator of inflation published by the Federal Reserve Bank of New York suggests inflation expectations are rising and that this will drive actual inflation higher.

Upside risks to US inflation

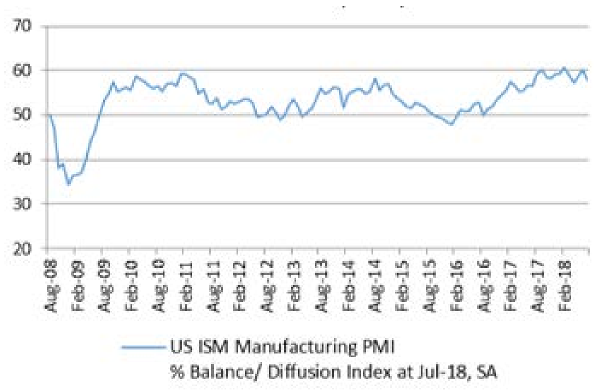


Source: DNR Capital

Growth

- The US economy grew by 4.1% in the second quarter, the fastest pace since 2014.
- Fiscal spending is also set to rise and the effect of the tax cuts has yet to fully impact the economy.
- Furthermore, business confidence remains high.
- Trump’s tweets and tariffs have kept a lid on investor confidence and we remain concerned that the economy is becoming overheated.
- This could potentially drive a stronger response from the Federal Reserve.
- Nonetheless, it remains supportive of economic growth.

US business confidence (PMI)



Source: DNR Capital

China

The Chinese Government has responded to concerns the trade wars would impact its economy by undertaking some stimulus activity.

- It has loosened monetary policy at the margin
- Accelerated tax cuts announced earlier this year and announced a new deduction for research and development spending
- Completing a VAT refund by September
- Issuing special bonds for existing key projects to accelerate completion of these projects.
- Encouraging lending by banks to government projects and small to medium sized enterprises
- Guiding financial institutions to use the reserve requirement ratio (RRR) cuts to support small and micro enterprises.

These policies should prove helpful for Chinese growth rates despite the uncertainty remaining regarding the outcome of trade policies.

Expectations for the reporting season

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- Has inflation impacted resource company margins?
- Will mining service companies benefit from the loosening of the purse strings by the major miners?
- How badly have the major banks been impacted by higher funding costs and the impact of the Royal Commission? Is asset quality deteriorating?
- Can the high PE growth stocks deliver on heightened expectations?
- Can laggards like Tabcorp Holdings meet subdued expectations?
- Are domestic companies being impacted by the higher cost of mortgages as interest-only loans are transferred to principal plus interest loans?

Portfolio positioning

Key Considerations

- Valuation vs. growth – reduced exposure to growth names including REA and TWE.
- Inflation – we are underweight bond proxies.
- Household debt to GDP is elevated. We are underweight consumer stocks and banks.
- Corporate debt is low and capex is rising. We have an exposure to companies exposed to mining investment and infrastructure spending.
- Resource cycle remains sound.
- Interest rate differential to the US suggests A$ weakness. We are overweight offshore earners.

Recent changes

- De-rated quality: companies such as BXB which are quite defensive with valuation support.
- Improving quality: TAH which has regulatory tailwinds.
- Stocks with sustainable growth but at reasonable valuations. These include LNK and CYB.

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