MEMO FROM:

John Morgan

DATE: **21 November 2018**

SUBJECT: **Taper Tantrum Round ?**

Fund Commentary

Capital Protection Trust #1 (CP1)
The CP1 aim is to invest in a portfolio of defensive assets that offer a diversified risk-weighted return superior to the Australian inflation rate. CP1 is structured to provide an efficient and effective mechanism for investors to gain access to a broad range of defensive investment opportunities that include Australian and international deposit products, corporate debt, Sovereign Bonds and mortgages secured by real estate assets. CP1 targets a return of 1.5% over the Australian CPI rate.

CP1 delivered a return to investors of 1.31% for the quarter to 30 September 2018. Since inception, the fund has returned 3.97% p.a. to investors.

Despite monthly volatility, the fund has returned to delivering yields broadly in line with its strategy to produce a a superior return over a 12-month period.

Growth Trust #1 (G1)
G1 is an absolute return, high conviction fund. We allocate capital to a small number of high quality domestic and international investment opportunities structured to deliver superior risk-weighted returns over a three to five-year period. The G1 investment universe includes Australian and international equities, alternative investments, listed and unlisted domestic and international real estate, opportunistic debt and private equity. As an absolute multi-asset fund, G1 is not designed to track or outperform any specific global or domestic market index, but to deliver long-term stable growth at lower levels of risk than equities markets. G1 targets a return of 4.5% over the Australian CPI rate.

G1 realised a return to investors of 1.59% for the September quarter and a return of 15.35% for the year to 30 September 2018. The fund continued to benefit from its global investments as well as the weaker AUD. Two factors weighed on the return: During the quarter, the fund made a number of large investments in a range of PE and property opportunities which incurred transaction costs. While we view these investments as having excellent long-term return prospects, they made no positive contribution to NAV; We now have more than 60% of other portfolio in unlisted assets and many of them report price movement periodically. In this quarter, there was no price movement in assets representing 38% of the portfolio.

The performance of the fund for the recent quarter was in line with target; however, equity volatility is likely to impact the portfolio moving forward. Our underweight position in global and domestic equities did protect the portfolio from the recent correction. While global and domestic equities are down approximately 10% from their highs, the G1 portfolio was only down 2% as at the time of this report, and this was before allowing for any improvement in the value of our unlisted investments.

High Yield Trust (HYT)
HYT is designed to provide investors with a secured regular income significantly greater than that offered by deposit and other debt products through access to a portfolio of Australian based loans primarily secured by first registered mortgage over Australian real estate assets. HYT's investment objective is to achieve this through:

- investment in primarily Australian credit assets that offer a risk weighted return materially superior to the Australian CPI;

- a high level of downside protection gained through first ranking mortgage security over Australian real estate assets at conservative loan to value ratios;
- development of a portfolio of assets with balanced maturities that creates opportunities for liquidity, but delivers high yield returns; and
- investment in wholesale and institutional investments that would not ordinarily be available due to the magnitude of the investment or the level of due diligence and expertise required.

The fund realised a return to investors of 1.70% for the September quarter and a return of 6.65% for the year to 30 September 2018. During the quarter average funds deployed were 75% of total funds.

Market and Economic Commentary

The Global Equities "correction"

It has only been approximately a month since our last report, but a very active period in global equity markets. All global equity markets realised significant corrections. Since early September, the ASX All Ordinaries has fallen 10.5% and the US S&P500 Index has fallen 7.3%.

There has been much discussion about what has caused this correction (defined as greater than 10% but less than 20% fall). Most pundits attribute it to recent escalations in the continuing trade war between the U.S. and China, falling margins and reduced profits for U.S. corporations, as well as the end of central bank accommodative policies. We note that these matters have been well known for months and limited new information has come to the fore. What we have seen is the US 10-year bond yield above 3.2% for the first time since the GFC along with increased concerns about global growth in 2019 and beyond. We are also seeing increasing confidence that there will be four more rate rises from the US Fed by December 2019. Given that all equities use the 10-year bond rate to estimate future equity value and global growth leads to better profits, we anticipate more of these equities shocks.

Equity markets are inherently volatile. Higher long-term return comes with higher risk. Corrections of more than 10% are not uncommon for equity markets. When they happen, they are invariably accompanied by calls of a bear market coming ahead of an impending recession. Occasionally, those calls are right, but more often than not they are premature and the market returns to its longer-term trend.

The graph below highlights that only four of 22 market corrections in the past 40+ years have led to bear markets (a greater than 20% top to bottom fall).

<u>**US market corrections 1974 - 2018**</u>

Source: Mason Stevens, Schwab Centre for Financial Research, Morningstar data for S&P 500

That said we have discussed the full valuation of the global markets and the potential for correction as interest rates return to "normal" levels. In anticipation of lower returns from equities, we have positioned our Growth Trust asset allocation accordingly.

The Global Economy

This excerpt from the RBA meeting of 2 October captures the state of the global economy very well

> *"The global economic expansion is continuing. A number of advanced economies are growing at an above-trend rate and unemployment rates are low. Growth in China has slowed a little, with the authorities easing policy while continuing to pay close attention to the risks in the financial sector. Globally, inflation remains low, although it has increased due to both higher oil prices and some lift in wages growth. A further pick-up in inflation is expected given the tight labour markets, and in the United States, the sizeable fiscal stimulus. One ongoing uncertainty regarding the global outlook stems from the direction of international trade policy in the United States.*
>
> *Financial conditions in the advanced economies remain expansionary, although they are gradually becoming less so in some countries. Yields on government bonds have moved a little higher, but credit spreads generally remain low. "*

In summary, the world finds itself in reasonable shape; unemployment is improving; growth is above average and interest rates are low. The concern is that this cannot last forever and we are coming out of the largest period of global financial stimulus in history, which must now be reeled in and we have very little in the way of a "play book" as to how things may turn out.

Also of concern is the potential for overheating in the US economy. With unemployment at it lows and US govt spending at record levels (combination of tax cuts and spending), the risk of wage and price inflation sparking concerns in the US is high. If this occurs and the US Fed has to increase interest rates rapidly, the risk of recession and a US bear market is high. Any US recession or severe market correction is likely to have contagion effects globally.

The Australian Economy

In Australia, the RBA continues to forecast growth to be a bit above 3% in 2018 and 2019, with the June result of 3.4% coming in as a recent record. However, the RBA also recognises global and domestic uncertainties, including an increase in short-term wholesale interest rates in Australia and the possibility of some further tightening of lending standards in the housing market, along with concerns over wages growth and the potential impact of the Australian drought.

The RBA remarked recently that that "The outlook for the labour market remains positive". However, we note that while unemployment is impressive at 5.0%, underemployment is high. As such pressure to grow wages with this slack in the labour market is low, which means the wages push inflation fears that exist in the US do not exist here.

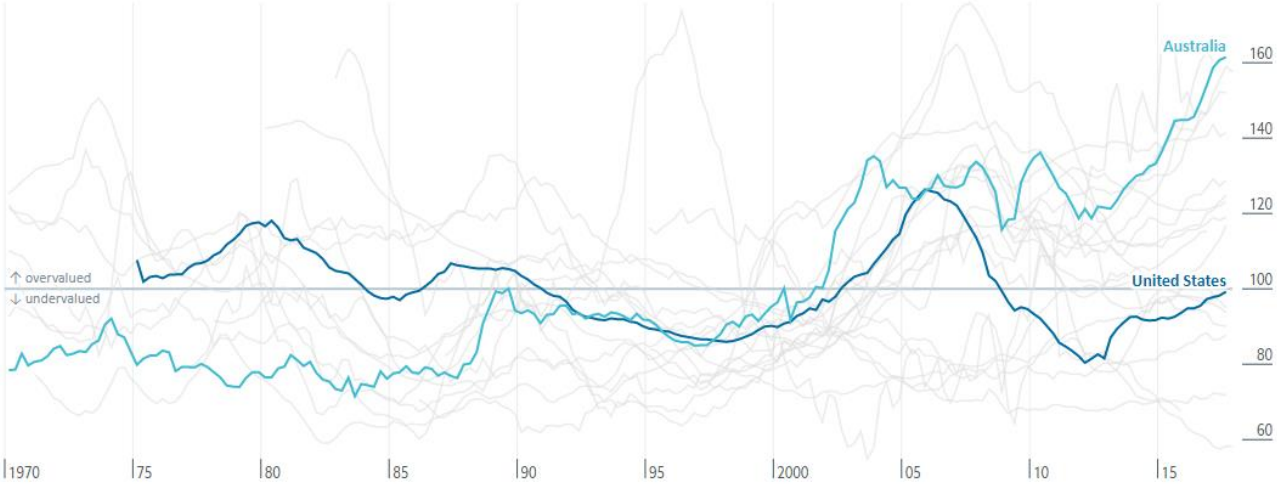
Adding to consumer concerns is the recent decline in housing prices, especially in Sydney and Melbourne where prices are down 6.2% and 4.4% from their respective peaks in July and November 2017[1]. The popular press is full of predictions of 20+% falls in prices[2]. Much of this, I feel are attempts to grab headline space. While the Royal Commission did highlight irresponsible lending practices and there are signs of a tighter home mortgage market, the Australian economy is in reasonable shape, with unemployment at current levels and low interest rates. Most Australians are under no pressure to sell their homes and at some point, supply will dry up. I am not saying that there are not more falls in the Australian property market to come. By any metric, Australian property prices are amongst the highest in the world (see charts below) and in Sydney and Melbourne prices have increased by more than 80% since the GFC. Tighter credit will affect capacity to borrow. However, in the absence of a disaster (China crisis, changes to negative gearing and capital gains rules, material increase in unemployment) the chance of Australia experiencing these headline price declines are low.

---

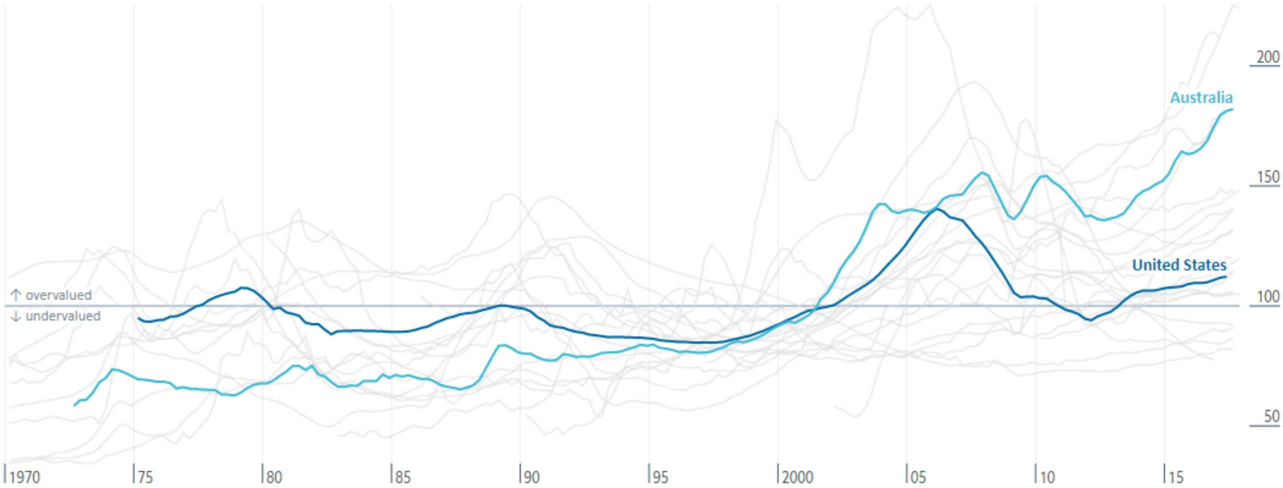
[1] *Source: CoreLogic.*

[2] *A recent UBS report stated prices could drop by 30% in the event of a "deep recession".*

Housing Prices to Income
1970 – 2018



Housing Prices to Rent
1970 – 2018



Source: *The Economist*
Note: *The grey shaded lines represent other countries*

Australia's terms of trade (ToT) have done well in recent years courtesy of higher price for some commodities, especially iron ore. Expected pressure on commodity prices are expected to lead to a decline in the ToT in 2019 which may also act as a drag in the Australian economy.

Interest Rates

Here in Australia, the general consensus is that the combined headwinds of low wage growth, declining real estate prices and slowing China growth will prevent the RBA from raising interest rates for another year. While many parts of the Australian economy are operating well, we believe it is this that points to the delicate situation in which the Australian economy finds itself.

While the RBA rate has been on hold since August 2016, market interest rates however have been on the rise with the 90-day bank bill rate having risen 25 bp and Australian banks announcing out-of-cycle rate increases to combat the effect of rising wholesale rates. Rising rates are unlikely to assist the pressure on housing prices, consumer confidence or inflation, which causes additional concern with respect to Australian growth.

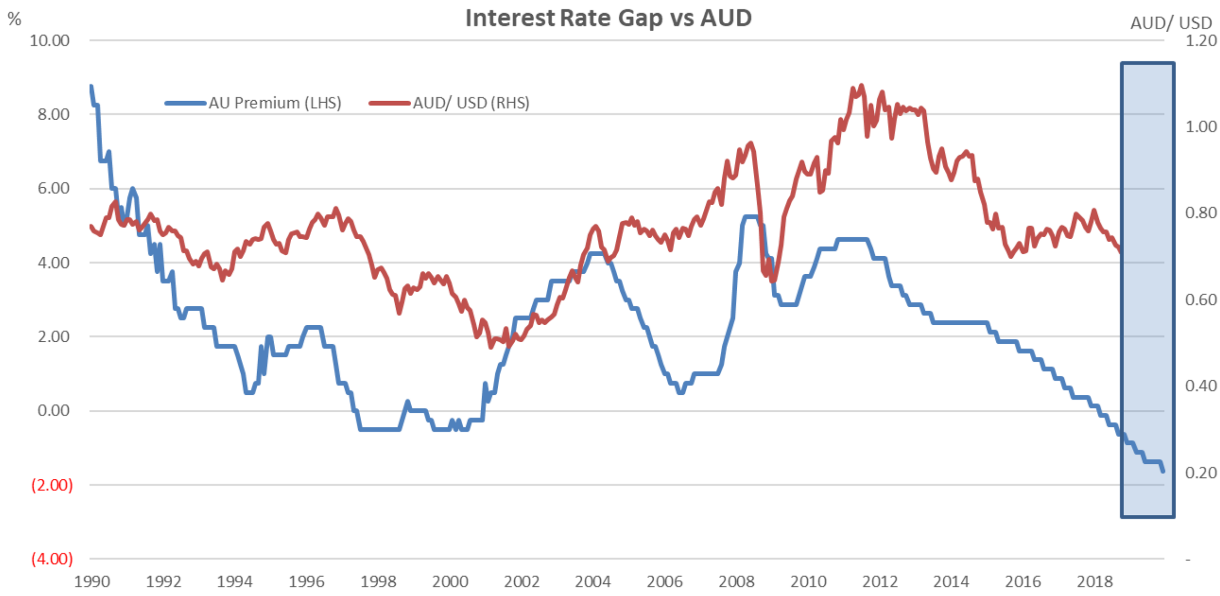
Conversely, the US markets increased again in September and a further 25bp hike is expected in December. With another three increases forecast for 2019 and none for Australia, that will make the interest gap between Australia and the US 1.63%. I pick this point up again in the next section.

Currencies

Recent downward pressure on the AUD has seen it trade at its lowest level against the USD since February 2016. The Australian dollar remains within the range that it has been in over the past two years on a trade-weighted basis, but it has depreciated against the US dollar along with most other currencies. The depreciation in the AUD against the USD has been quite severe albeit somewhat abated by the recent weakness in the USD due to the mid-term election results.

The graph below compares the AUD/ USD rate to the difference between the Australian RBA Cash rate and the US Fed Rate. While the AUD is affected by numerous factors including commodity prices and Chinese growth, there is a correlation between the rate and this difference as it affects the global flow of money seeking higher interest rate return.

Prior to September this year the largest negative difference between these two rates was 0.50% when the gap turned negative between July 1997 and December 2000. During that period, the AUD fell from a high of 80 cents in December 1996 to a low of 49 cents in March 2001. If the anticipated rate rises occur in the US over the next 12 months and the RBA keeps rates on hold, the gap between these two rates will increase 1.625% by December 2019. While there are many other factors that affected the AUD/ USD exchange rate between 1996 and 2001 and equally so many that affect rates today, this analysis forms a large part of the support for our view that the AUD has its risk skewed to the downside.



Source: US Fed, RBA, CTE analysis

Effect on our Portfolio Strategies

Growth Trust #1

There is no question that GDP growth (US and Australia) and corporate earnings (US) have been strong in 2018. While US tax cuts did inflate US earnings, underlying growth has also been strong.

However, there are a number of potential global risks which include:

- rising US inflation leading to faster Fed tightening;
- continued low growth in Europe;
- the longer-term impact of the power battle between China and the USA; and
- contagion from an Emerging Market debt crisis.

while here in Australia, we remain cautious about:

- an acceleration of the housing downturn brought about by the tightening of credit in response to the Royal Commission and lower demand out of Asia;
- low wage growth combined with high household debt; and
- mooted changes to negative gearing and the value of franking credits.

1.

In 2019, I anticipate that global growth will slow. This combined with increased interest rates is likely to create headwinds for equity prices globally and there is definitely the possibility of a US recession in late 2019 or 2020.

As such, G1 continues to have a lower exposure to listed equities than most multi-asset strategies and will continue to do so while these conditions remain in effect. Our first goal always will be to not lose money. To account for this underweight position in equities, we continue to seek out non-equity investments that we believe while having equity like risk have higher expected returns over the medium term. One potential impact of this is that returns will be less volatile but more lumpy, not necessarily occurring every quarter.

High Yield Trust

While the HYT has performed to target, we were only 75% invested for the quarter. As at the date of this report, we are now fully invested and anticipate that this should improve the fund yield in the December and March quarters. We continue to be very cautious about which loans we invest in, working to minimise any risk of capital loss.

Capital Protection Trust #1

The Capital Protection Trust is our most defensive fund. While it experienced volatility in the first half, we have recovered all short-term losses and continue to deliver above our targets in the medium and long term. We continue to seek out defensive investments with returns that meet our targets. While we have outperformed our targets in the past, capital protection will always be our primary goal in this trust.

To our investors, I thank you for your continued support and as always, I welcome your comments and questions.