Portfolio performance

The portfolio returned 13.86% over the six months to December 31 after fees, outperforming the All Ordinaries Accumulation Index and MSCI World Index by 3.92% and 3.65% respectively.

Market conditions

The MSCI World returned 10.21% in AUD for the six-month period to 31 December 2016, and most of the return was delivered in the final two months of the calendar year. The market proved to be volatile again, following the US presidential election and the BREXIT vote.

The US election provided a catalyst driving share prices higher however President elect Trump will need to deliver on his election promises. We are concerned about the prospect of trade protection and the impact this may have on the global economy.

The US has been a clear beneficiary of market liberalisation over the last decade as evidenced by their advance in Gross Domestic Product per person, currently US$51,549. However, this growth has come at the expense of the lowest quintile of income earners as many in the US have been getting richer while greater income inequality has been rising.

The UK appears to have weathered the initial shock of the BREXIT vote, although the value of the pound remains at a 30-year low. As we noted previously, the impact of a UK recession on global growth would be negligible. The Bank of England is hoping its decision to cut interest rates from 0.5% to 0.25% will stimulate economic activity and avoid a downturn. Time will tell.

A discussion of the last six months would not be complete without considering oil. The price of crude oil has significantly recovered from its low of $26.21 in February this year. The market expects oil to rise toward US$60 per barrel following the landmark agreement to reduce production between OPEC and non-OPEC nations.

From a global perspective, we expect moderate economic growth in 2017. However, we see rising interest rates and an overvalued bond market as the key risks on the horizon for asset prices and the economy.

Portfolio Investments

At a sectoral level, the fund benefitted from positions in Information Technology, Financials and Energy. It was not surprising our largest return came from investments in Information Technology. We own several stocks that fall into this category. Despite this GICS classification, the underlying businesses of these companies are diverse. For example, the drivers of Microsoft and IBM are not the same as the drivers for Visa and MasterCard.

At an individual investment level, the fund benefitted from its positions in Deere & Co, JPMorgan and Phillips 66. The Deere & Co share price rallied as the company delivered earnings that significantly exceeded market expectations. Phillips 66 was a beneficiary of the higher oil price and a recovery in the 3-2-1 crack spread. JP Morgan enjoyed a share price rally as the prospect for interest rate rises grew in the US.

General Electric (GE) and Johnson & Johnson detracted from performance over the period. We exited our position in GE, increasing our weighting to companies that are cheaper on a relative and absolute basis. We used the proceeds to increase our weighting in Wells Fargo and JP Morgan prior to the US bank rally.

In terms of portfolio concentration, our top 5 holdings account for 38% of the portfolio and our top 10 holdings account for 62%. Both percentages increased over the period.

Outlook

The US economy continues to strengthen, supported by a robust housing market and employment growth. The unemployment rate continues to fall reaching 4.6%, down from around 10% in 2009.

It is instructive to look at the US Treasury Yield curve as a leading indicator for economic activity. Presently, we have an upward sloping yield curve, a positive for equities and economic growth. An upward sloping yield curve signifies financial markets are expecting higher interest rates in the future. In contrast, an inverted yield curve like the one that preceded the Global Financial Crisis warns of tougher times ahead. Historically, a yield curve becomes inverted 12 to 18 months before a recession which leads us to conclude, on balance, that economic growth should continue in 2017 – save for a large dislocation in the bond market.

Moreover, we believe the bias to the forward curve is to the upside. Infrastructure spending and public investment should

provide an economic tail wind. Deregulation of the banking industry will also provide a boost to economic growth in the form of accommodative credit conditions. As credit is the grease which lubricates the wheels of economic activity a loosening of credit regulation is a positive catalyst for equities and economic growth. On balance, we see the scales tipped toward growth in 2017 driven by moderate inflation, fiscal expansion, and financial deregulation.

While these conditions are supportive of higher inflation, there are deflationary forces that should keep this contained.

Output Gap

There is still slack in the economy – a feature of below trend growth. This leads us to believe inflation will be modest in 2017, despite wage inflation increasing for the first time in many years.

Government Balance Sheets

Globally, government balance sheets have expanded from $6 trillion to $21 trillion. This large increase in government debt may manifest in a financing squeeze producing a deflationary force on income growth and asset prices.

Counterbalancing these deflationary forces is the prospect of trade protection. An outcome of a more protectionist US administration could see inflation move higher than is presently expected by the market. The implications of higher inflation would be felt most acutely by the US bond market.

After a bull run spanning 35 years, the bond market enters the new year with a significant risk of a correction. Rising interest rates, coupled with the removal of central bank stimulus could exacerbate a correction that has been decades in the making. These conditions provide a confluence of forces with the potential to impact all asset classes.

Rising interest rates have implications for global investors as the risk-free rate is the yardstick that all other asset classes are evaluated against.

Outside of these economic factors, there are a number of structural factors to consider:

- A large increase in government debt, which has reached historic levels.
- Quantitative easing has reached its limit of effectiveness.
- The aging population sees the ratio of workers per retiree declining.
- Large unfunded liabilities at local, state and federal levels in pension and healthcare.

We believe the effect of these factors will manifest in a financing squeeze producing low income growth and low investment returns over the medium term. Unfunded pension and health liabilities will place a toll on governments which may respond by increasing taxes.

The three main risks for Australian investors are a slow down in China or the domestic housing market. A rerating of the government's credit status would also impact markets.

We are circumspect about the recent rally in commodity prices. Despite strengthening commodity prices providing relief to our terms of trade we question the long-term sustainability and are worried about the sensitivity to a Chinese led slowdown. If we roll back the clock to 2009, Australia was drawn out of the Global Financial Crisis by China. Unfortunately, this time, a China slow down may occur at the same time as the inevitable housing slow down arrives.

The Australian economy is under pressure, with real output, employment and wages growth deteriorating. Treasury has been cautious with its latest round of predictions and is forecasting commodity prices to weaken in the years ahead. This will see the deficit surge through to 2019-2020. Although Treasury expects a return to surplus in 2021 we put very little faith in its forward projections.

A primary focus for the new US administration will be to reduce the trade deficit with China, presently US$365.7 billion. The relationship is heavily weighted toward China which exports significantly more goods and services to the US than it imports. Since joining the World Trade Organisation in 2001 under President Clinton, the US manufacturing base has been decimated and many believe this was facilitated by an undervalued Yuan.

President elect Trump campaigned for a withdrawal from the Trans-Pacific Partnership (TPP) and renegotiation of the North American Free Trade Agreement (NAFTA). The 12 nation TPP is President Obama's signature trade initiative which has been signed, but not ratified by Congress.

Donald Trump's decision to appoint Peter Navarro to oversee US Trade and Industrial policy is an interesting appointment. Peter Navarro is professor of economics and public policy at the Paul Merage School of Business, University of California, Irvine. After reading his book "Death by China", we believe he will take a hard line stance with China. A trade or currency war could have significant implications for China, Australia and global growth.

According to President elect Trump China maintains the value of the Yuan in too low a range. He publicly lambasted China during his campaign, referring to it as a currency manipulator and raising the prospect of a 45% tariff on Chinese imports.

Despite China's official GDP growth estimates looking seemingly robust, we are concerned about the long-term sustainability of this growth. China has pivoted away from consumption led growth back to investment led growth, which is being funded for the most part through debt.

What we saw in the most recent economic numbers showed fiscal spending increase by 12% over the past 12 months while fiscal income increased only 3%. This indicates they are borrowing significantly to boost GDP numbers. This is unsustainable behaviour and coupled with the continuing reclassification of debt, places China in a precarious situation should there be a significant downturn. Any event of this nature could have negative ramifications for Australia and Australian investors.

Our job as a global investment manager, is to allocate capital to the highest producing regions and select the highest producing companies that can benefit from the prevailing economic conditions. The US still offers the best risk-reward equation after considering the effects of currency on the investment. We expect a tightening credit market in the US to drive a strengthening of the US dollar against the Australian dollar.

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