JM Financial Group

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Investment Newsletter

Market Performance (As at 31st May 2016)	May 2016 (%)	Calendar YTD (%)	1 Year Rolling (%)
S&P - All Ords Accum. Index	3.09	3.92	-1.25

Month in Review - *A review of events that influenced the share market in May.*

There is an old adage in share markets, *"Sell in May and go away, do not return until St. Leger's Day"*; this of course makes limited sense unless you're a stockbroker in ye olde English times when the St. Ledger's Stakes marked the end of the summer and the return to work.

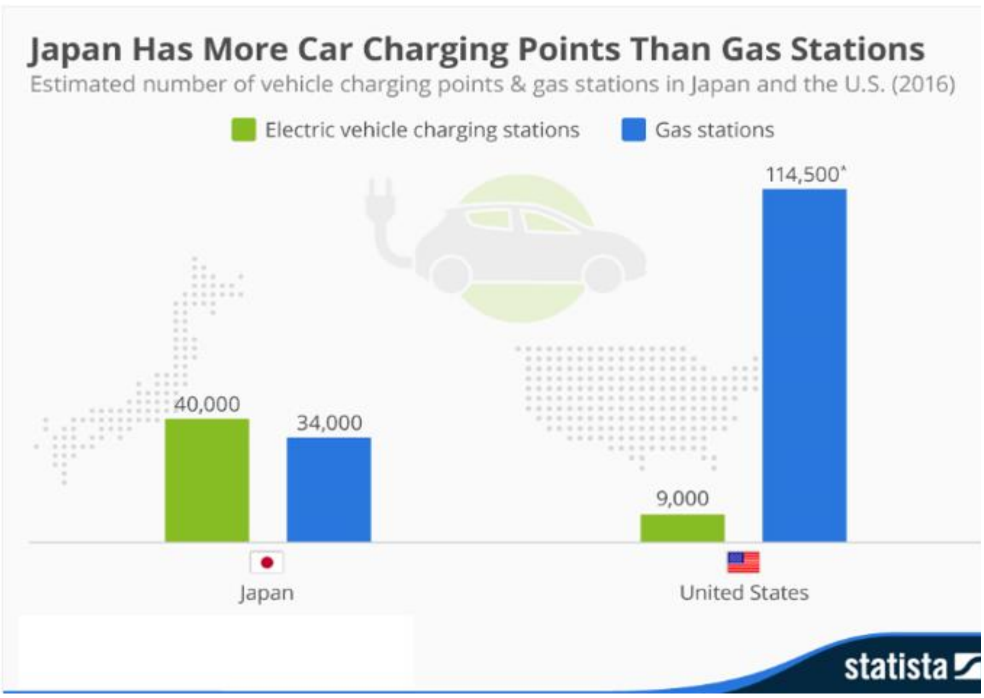
Whilst the adage has morphed over time and three month holidays are just a mere daydream, the saying has, at various stages, been a reasonably effective indicator of market performance with the northern hemisphere summer being somewhat of weak patch for market returns. With the All Ords rising 3% for the month of May it's safe to say selling would not have been a wise move so far and highlights just how hard it is for investors to "time" entries in and out of the market.

After witnessing a number of conflicting economic reports earlier in the year it appears US equity investors are now gaining confidence that the US economy can handle further interest rate rises with Federal Reserve Chair, Janet Yellen, indicating it would be appropriate to raise rates in coming months. In very healthy signs for markets the Dow Jones rose on the back of this news and posted a positive gain for the month.

Although it appears that the US economy may finally be turning, Australia's domestic economy continued to drag with interest rates being cut by 25bp to 1.75%, a record low. This relatively un-forecasted move by the RBA took a number of commentators by surprise given the close proximity to a federal election and the announcement being made only hours before the release of the 2016/2017 fiscal budget.

The cautious views of the RBA were somewhat justified later in the month with a number of consumer facing businesses highlighting a weak operating environment. This culminated in a $1.6bn impairment of Target by Wesfarmers, an earnings downgrade from Beacon Lighting and Murray Goulburn cutting milk prices and earnings due to global dairy price weakness. After what can only be described as a disastrous start to public life Murray Goulburn's move to cut milk prices caused outrage and threw the dairy farming community into turmoil.

Chart of the Month – *who killed the gasoline car?*



During the month Nissan Motor Co. presented the intriguing news that there were now more electric vehicle charging stations in Japan than gasoline stations.

Although the electric numbers include personal charging stations this is a clear indication of the increasing acceptance of electric and hybrid vehicles.

Charging infrastructure has long been one of the key impediments to electric vehicle penetration and this chart further reinforces the potential for electric vehicles to gain a foothold in the market. We discuss the electric car market in more detail later in the newsletter.

Thematic Discussion – *resource rally or dead cat bounce?*

After a three year period of poor performance the Top 200 Materials Index has been the star performer this calendar year, rising 16.4% versus the Top 200 Industrial Index rising 8.8% and the Top 200 Financials Index falling 3.7%. The rise has been driven by a 32% increase in crude oil prices, a 15% rise in gold prices and a 37% increase in iron ore prices. This has flowed through to the equity markets with fourteen of the top twenty performers this year being mining or mining service companies.

Whilst these moves have been impressive on a two year basis we can see the Materials Index is still trailing the Financials Index by a large margin.

For many years slowing Chinese growth and lack of US demand caused a great deal of pain for large resource companies leading to very public downfalls in BHP, Rio Tinto and Fortescue and forcing a number of small resource companies into administration.

The question for equity investors now is whether this most recent bounce is a dead cat bounce or a sustained return to growth?

As previously alluded to we don't profess to be able to predict the future or for that matter, future commodity prices; a fool's errand if ever there was one.

We do observe however and what we are currently observing is weak global growth. As little as a week ago the OECD (the Organisation for Economic Cooperation and Development) urged governments to stimulate their economies amidst deteriorating economic conditions. The OECD now expects the US economy and combined OECD nations to grow 1.8% this year, revised down from 2.5% and 2.2% respectively in November 2015.

Although we tend to take global growth forecasts with a grain of salt the trend is worrying with growth forecasts continuing to be reduced – not a scenario that reflects heightened demand for resources and reinforces our view that the resource market still carries a great deal of short term risk.

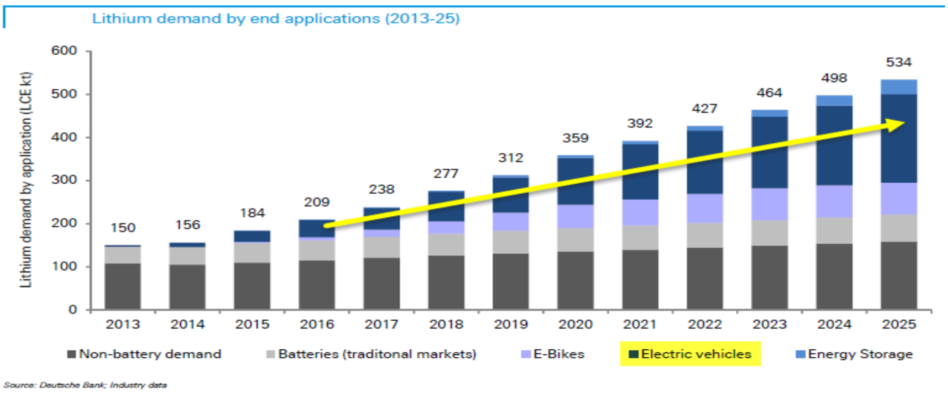
Sector Discussion – *Lithium and the Electric Vehicle (EV) Battery*

Every so often an emerging trend takes hold in markets and provide extraordinary opportunities and returns, only to burn brightly for a period of time before dwindling as the bubble bursts. On the rare occasion an emerging trend becomes a new paradigm (think Facebook, streaming video on demand and online shopping). One of the hardest aspects is identifying what is sustainable and what is indeed a bubble.

Tesla is potentially one of these new paradigms having taken their electric car from concept to production over the last 13 years. At its most recent quarterly update, Tesla's enigmatic CEO, Elon Musk, forecast that the company would be producing 500,000 electric vehicles by 2018 and one million vehicles by 2020. To quote Musk, "In order to produce half a million cars a year…we would basically need to absorb the entire world's lithium-ion production".

As an important component of the electric battery, lithium is in high demand and Musk's comments only served to further fuel a flame under the metal, whose price had already risen 47% in the first quarter of 2016.

In fact, lithium carbonate pricing is forecast to triple from $9,000 USD/t in 2015 to $21,000 USD/t in 2016 before settling back to $10,000 USD/t in 2019 as more supply enters the market.



Despite having a third of the world's production, Australia only has one listed current producer, Orocobre (ORE), which oddly enough produces lithium from a deposit in Argentina. The other Australian companies with projects looking to commence production in the next few years are Mineral Resources (MIN) and Neometal's (NMT) Mt Marion resource, Galaxy (GXY) and General Mining's (GMM) Mt Cattlin resource and Pilbara Minerals' (PLS) Pilgangoora resource. To say we are late to the lithium story is somewhat of an understatement with GXY, GMM, NMT, PLS and ORE up 334%, 225%, 203%, 106%, and 103% respectively since January 1st this year.

The major risk for these companies is that *finding* lithium and *producing* lithium a two very different notions with deliverability being the Achilles Heel for many a resource company. At this stage we feel there are too many unforecastable variables at play to confidently invest in the Australian lithium companies but we are following the sector closely given our view that the electric car market is indeed an exciting new paradigm.