JM Financial Group

Issue 28: August 2017

Investment Newsletter

Market Performance (As at 31st August 2017)	Month To Date (%)	Calendar YTD (%)	1 Year Rolling (%)
S&P - All Ords Accum. Index	+0.79	+3.89	+9.20

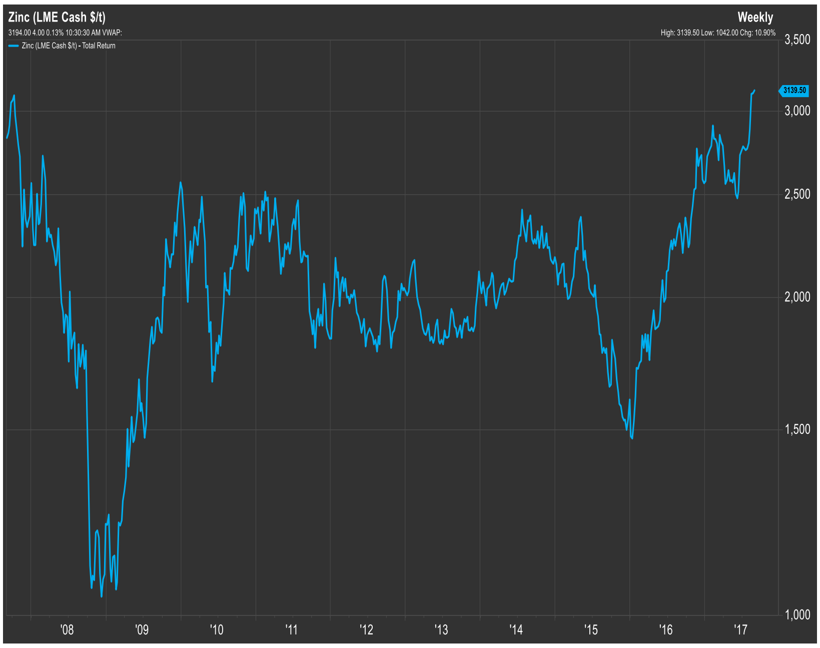
***Month in Review** – A review of events that influenced the share market in August.*

The All Ordinaries Accumulation Index increased 0.79% for the month but there were wide variations within the sub sectors of the All Ordinaries Index. Strong performances across the resource sectors led the market in August with total returns for Materials +4.44%, Metals +5.04%, Golds +11.30%, and Energy +5.74%. Other strong sectors in the month included Consumer Staples +5.33%, Industrials +4.63% and Utilities +3.15%. Weak sectors included Telecommunications -7.37%, Financials -2.19%, and Consumer Discretionary -1.47% while Healthcare +0.27%, I.T. +1.91%, and Property +1.28% were relatively flat.

There was good underlying strength in the market in August with two major drags limiting overall performance. CBA and Telstra fell 6.9% and 6.6% respectively on a total return basis, which incorporates dividends accrued to shareholders through the month, $2.30 for CBA and $0.155 for Telstra, both fully franked. CBA was hit on the news that civil penalty proceedings had been initiated by AUSTRAC for alleged non-compliance with the Anti-Money Laundering and Counter Terrorism Finance Act 2006. Telstra was hit on another poor operating result, a mediocre outlook, longer-dated concerns around the full financial impact of the shift to NBN and later in the month on NBN's refusal to provide technical consent for Telstra's securitisation proposal relating to NBN's annual payments to Telstra.

On a combined basis CBA and Telstra represent around 10% of the index, hence would have detracted around 70 basis points from performance during the month. Excluding these stocks the broader market would have risen in the vicinity of 1.5%, but as highlighted previously this was driven by resource-based businesses. Generally speaking, the outlook statements provided to the market through reporting season across larger capitalisation companies were a bit ho-hum with Telecommunications, Banks, and Consumer Retail businesses likely to be challenged in the year ahead with moderate growth at best. Many of the smaller capitalised companies, particularly a number of those within the I.T. and Financial Services sectors, did provide quite promising outlook statements.

Chart of the Month – Zinc Prices US$/t



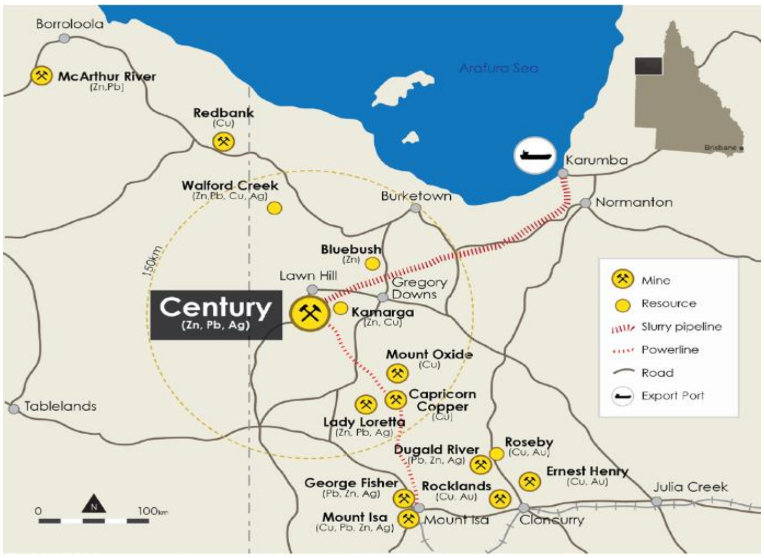
The zinc price has experienced a significant recovery in the past two years, in part reflecting production closures, along with growing demand on the back of global economic growth. China, producing over 40% of global annual zinc, has cut production by 10% to 4,500,000t. The largest cut has come from Australia where production has halved to 850,000mt, largely due to 2016 closure of the Century Zinc mine, which had produced up to 500,000t annually.

Under the proposal to reopen Century Zinc, the tailings processing proposal will see less than 200,000t added back to annual production. As capacity comes on we would expect moderation in the zinc price with a realistic long term price range of US$2,000-2,500/t based on zinc prices over the past decade.

Note the volatility with prices falling to abnormally low levels around US$1,100/t during the GFC and close to US$1,500/t at the end of CY15 early CY16, a period of weaker global growth.

Due Diligence – *a closer look at a stock of interest*

New Century Resources (NCZ)



New Century Resources (NCZ) has taken control of the Century Zinc mine in Northern Territory. This mine closed operation early 2016 when zinc economics were poor. With all infrastructure in place and well maintained, and a significant recovery in the zinc price, the economics of the operation have changed substantially.

The initial plan is to process the 71 million tonnes of indicated and inferred tailings at 7 million tonnes per year, with a zinc grade of 2.73% inferred but averaging 3.20% average in recent testing. Annual production of 122,000-144,000mt is possible. At a sale price of US$2800/t revenues of A$400-500m would be possible.

Mine processing charges of US$0.30-0.40/lb are anticipated. Add transport and other costs, all up costs could amount to US$1000/t of concentrate.

If concentrate can be sold to smelters at 85% of its content value, NCZ should be able to generate A$225m-325m in annual pre-tax cash-flow at a zinc price of US$2,800/t. Every a US$100/t change in the zinc price would see pre-tax cashflow change by $10-15m. Risks are high. Firstly the zinc price can be volatile and while the outlook is encouraging with growing demand and low stockpiles, production can ramp up and price can move quickly. In addition the processing of tailings has been tested at the site but has not been done on a bulk basis and as such cost structures could also vary. In the context of an enterprise valuation of $175m, NCZ looks interesting.

Managing Portfolios In A Mad World

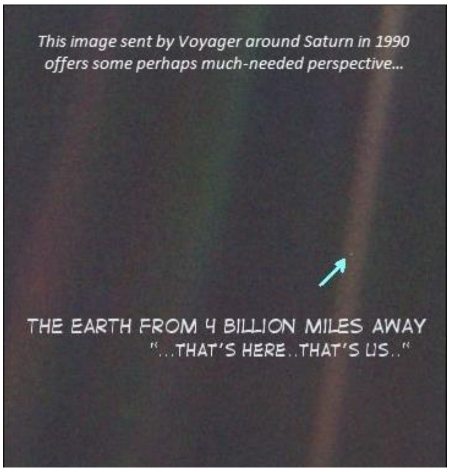
The world really does seem to be a crazy, confused place at present. Some would argue we have some of the wackiest leaders the world has ever seen. Trump, Putin, and Kim Jong-un are all classic chest-beating politicians. Trump we now know has a thin hide, particularly in relation to media criticism but more broadly to anyone that cares to criticise or have a different view. Big on brash talk and often with seemingly little consideration, diplomacy within a tense global landscape seems to be an unlikely outcome on his part. Putin seems to be one not to stand down, even to threats of being shirtfronted by Australian Prime Ministers. Kim Jong-un appears determined to continue his intimidation of Trump and the Western world in what must surely be a no-win solution should his invitation of violence be accepted.

So how should equity portfolios be managed, with the backdrop of this unusual political landscape? Our view is that they should be managed on the same basis as we would normally manage them. There are always uncertainties and there are always fears of worst-case outcomes, but very rarely do they eventuate. Even if they eventuate, they are not necessarily worst-case outcomes for markets. Markets can still appreciate through periods of global political instability and war. Of course, should the worst-case eventuate in relation to the Korean Peninsula, we would reassess our positioning in the market. A violent resolution, in all likelihood, would be a short-lived event. There may be sectors of the market that might perform quite poorly in this situation. The Financial sector, for example, including insurers, could come under serious pressure. Demand for Resources, however, would most likely rise, as would demand for skilled services, such as engineering, technology, health etc. Whilst no one in their right minds would want a violent outcome – potentially having a devastating effect on many lives – it is not necessarily a reason to be under-exposed to equity markets, particularly once the event has stabilised.

The big unknown, of course, is whether markets and economies would react in a similar fashion as they did during previous war-time events. The nature of war on the Korean Peninsula would be very different to anything seen before and could have consequences well beyond the Korean Peninsula if North Korea is capable of arming long range missiles.

We can only hope that common sense prevails and a sensible solution is found. We can only advocate diversification which, regardless of environment, is always the mantra of sensible investment.

Hoping for rational outcomes from seemingly irrational minds.



This August also marked 40 years since humanity launched Voyager into space to "take a look around". NASA tweeted that they sent a recording by William Shatner to Voyager to commemorate the 40th Anniversary; the message: "We offer friendship across the stars. You are not alone."