JM Financial Group

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Investment Newsletter

Performance *(As at 31st January 2018)*	**Month (%)**	**Rolling 3mths (%)**	**Rolling 1yr (%)**	**Rolling 3yrs (%)**	**Inception (%)**
JMFG Australian Equities Strategy	**-0.23**	**+3.71**	**+15.53**	**+40.39**	**+47.94**
All Ords Accumulation Index	-0.33	+3.63	+12.96	+26.07	+33.23
Outperformance	**+0.1**	**+0.08**	**+2.57**	**+14.32**	**+14.71**

Although the JMFG Australian Equities Strategy is generally representative of client portfolios, Individual performance may differ from the results above. These differences can arise due to various issues, some of which may relate to initial timing of investments and cash inflows and outflows. Performance is calculated on a TWRR basis; non-annualised, and includes fees (post 1 Jan 17) but excludes the effects of franking credits and tax. Strategy Inception for Performance Data is July 1st 2014.

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

The All Ordinaries Accumulation Index fell a modest 0.3% in January and was probably due for a breather, after rising nearly 15% in CY17 and over 8% in the final quarter of the year. Rising global interest rates again became a focus of equity markets, with concerns that synchronised growth would lead to inflation/wage growth and hence a concern that global interest rates could potentially rise faster during CY18 than previously anticipated. As a result the income related sectors were the worst affected in January. Utilities fell 4.5%, Property Trusts fell 3.3%, and the Industrial sector, whose major components are Transurban and Sydney Airports, fell 2.1%. The Health sector had a good month, rising 3.2%, with its two major stocks, CSL up 3.6% and Cochlear up 1.5%. The I.T. sector rose 2.0% in the month and most other sectors finished +/– 1% of the prior month end. The ASX Small Ordinaries Accum Index fell 0.5% in January.

Spot commodities were mixed in US$ terms, with iron ore pushing toward US$80/t during the month but closing nearer where it started, at US$73/t by month end. Energy products continued to show strength rising 3-7% with oil prices pushing into the high US$60/b range. Amongst base metals, nickel and zinc rose 8-10%, lead rose 5% and copper fell marginally. Precious metals were stronger with gold up 4-5% and platinum up 6-7%. Prices in A$ were offset to some extent with the A$ rising from around 78c to 81c. Agricultural prices continued to be buoyant with US beef, wheat, and wool prices steady to strong.

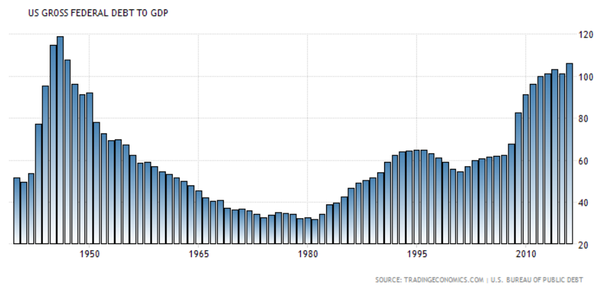
As stated last month we go into CY18 with a degree of optimism around earnings growth and forward consensus Price to Earnings multiples holding above 16x. Synchronised global growth should help to support the Australian economy. The International Monetary Fund projects global growth improving from 3.2% in CY16 to 3.6% in CY17 and holding around this level for CY18. The US tax reforms may well be the wild card. Significant reductions in corporate tax rate from 35% to 21%, and lesser reductions in personal tax rates are estimated to add US$1.5 trillion to national debt over the next decade. Without an improvement in economic growth and employment, US national debt could ultimately become a major burden on the US economy and the US$. Current US national debt stands at over US$20.5 trillion, which equates to over US$63,000 per citizen and over US$170,000 per US taxpayer. *(Source: US Treasury & Federal Reserve)*

Charts of the Month – Gross Debt to GDP

US national debt stands at over US$20.6tr, which compares to US$19.8tr for annual US Gross Domestic Product. US Federal tax revenue is around US$3.35tr annually with Federal spending at US$4.04tr, hence its annual national debt is growing at about US$685b per year. *(Source: US Debt Clock.org)*

US Gross Federal Debt stands at 104% of GDP, a traditionally high level but other developed nations are at higher or similar levels. For example Japan is well over 200%, Singapore is around 110%, Spain and France are both around 100% and the U.K. is around 90%.

Australia's Government Debt to GDP is low by comparison at 40%, but has increased from sub 10% to over 40% over the last decade. The magnitude of the increase is broadly similar to the US, where its Debt/GDP ratio has increased from sub 70% to over 100% in the same timeframe. Whilst growing Debt to GDP ultimately needs to reverse, the cost to service debt is very low by historic standards but rising interest rates will be a concern.



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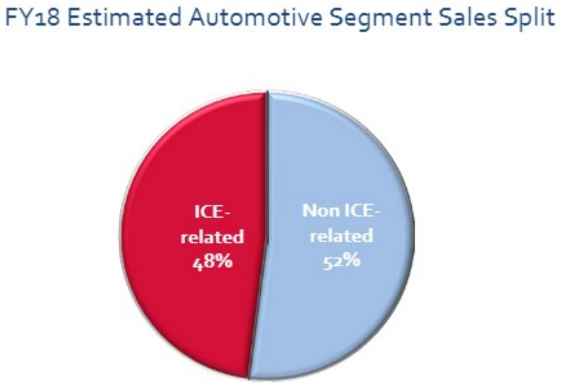
Due Diligence – *A closer look at a stock of interest*

GUD Holdings (GUD)

Good, bad or ugly, GUD is always an early reporter of its results – this early release of the half-year result lets us focus on the whole period in this article. Another set of strong underlying results was delivered, but this time without the disappointing losses ($59m loss reported in FY17) on its discontinued operations. NPAT from its continuing operations increased 16% to $25.8m, and the company announced a 24c fully franked interim dividend, up from 21c in the previous corresponding half.

Internal Combustion Engine (ICE) Exposure



In its core Automotive division, sales increased 14%, to $142m, and EBIT increased 12%, to $40.2m, for the half. The Davey water pump business achieved 2% sales growth, to $52m, and 9% EBIT growth, to $4.7m. The recent sale of Oates (janitorial & household cleaning products) for $80m will initially be used to retire debt. The funds raised will also provide capacity to continue to grow the Automotive division, including the recent acquisition of AA Gaskets for $16m. One concern around GUD is the impact the electric vehicle might have on ICE components.

We believe that, despite this threat, GUD still offers growth in the supply of non-Original Equipment. Hybrid & electric vehicles currently represent less than 1% of the market, and it will take years to replace the 13.8m ICE vehicles on Australian roads today. This process won't begin in any meaningful form until fully electric vehicles (EV) represent good value and offer a per-charge range that is at least comparable to the range of ICE vehicles. In the meantime, we expect GUD to continue to service a still-growing ICE vehicle market, while building diversification into non-ICE products, with potential acquisition in more ubiquitous areas of brakes and suspension.

Market Collapses & Corrections

The roaring twenties was a period of rapid innovation with the radio, telephone, automobile, aviation and electric power grids providing a combination of greater information and automation that drove many industries. The Dow Jones Industrial Average (DJIA or "the Dow") through the 1920's increased from around 65 points in 1921 to a high of over 380 points by mid-1929. By 1932, the Dow had lost 89% of its peak value to hit a low of 41 points. The October 1987 crash was far less severe, by comparison, with the DJIA having risen from 776 in August 1982 to 2,722 by August 1987. The crash of 1987 began in October, with an initial fall of 3.8% on the 14th, followed by 4.6% on Friday 16th and 22.6% on Monday 19th October. From October 14 to October 19 the Dow had lost 31% of its value, but the market began to rally immediately, and had recovered its losses by September 1989. The crash of 1987 was not preceded by a c600% increase in the years prior – rather, it was nearer 350% – and the fall equated to only 1/3rd of the fall experienced from the 1929 peak through to 1932.

In the crash of 2008-2009 (GFC), the DJIA dropped 54% to 6,469, from a peak of 14,164. From its lows, the Dow has subsequently increased by 400%, and the S&P 500 by 460%. On those increases alone, a correction would not be a surprise. However, it is worth noting that the increases for each index are from extreme low points – which, in comparison to our 1929 and 1987 crash analysis, might seem unfair. Market crashes typically occur after periods of excessive gains, whereas corrections are often related to an event.

The GFC was an event-based crash where the GFC event ultimately unwound the stellar rise in the years prior. While the 1987 crash quickly reversed over the following two years, high global interest rates ultimately led to market corrections from 1989 to 1991. The Oil crisis in 1973/74 and Asian crisis in 1997 were other events that saw significant market corrections and subsequent recovery over time.

We do not make predictions around crashes, but we do adjust cash positions to reflect changes in perceived risk. Generally, we are holding larger than usual cash positions to reflect the current increased risk, which reflects the rise in the market and relatively high market multiples. Should earnings growth, driven by synchronised global growth, occur through CY18, we are hopeful that the Australian market ends the year higher than where it started – we attribute ~75% probability to this outcome. However, the downside risk could see a pricing correction of 20%+ (~10% probability with ~15% probability of a flat/mildly down market over CY18).

Overall, on a risk-weighted basis, we are currently carrying cash levels across portfolios in the 10-20% range, versus more usual levels of 5-10% – although this may change at short notice as opportunities arise.