JM Financial Group

Issue 36: April 2018

Investment Newsletter

Performance *(As at 30th April 2018)*	**Month (%)**	**Rolling 3mths (%)**	**Rolling 1yr (%)**	**Rolling 3yrs (%)**	**Inception (%)**
JMFG Australian Equities Strategy	**+2.64**	**+0.02**	**+8.26**	**+32.75**	**+47.99**
All Ords Accumulation Index	+3.49	0.00	+6.44	+19.62	+33.23
Outperformance	**-0.85**	**+0.02**	**+1.82**	**+13.13**	**+14.76**

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 April*

The All Ordinaries Accumulation Index recovered in April, rising 3.49%, broadly offsetting the 3.55% fall in March. JMFG's Australian Equity Strategy increased 2.64% in April, underperforming the market for the month. It is however in line with the market over three months, after costs and is ahead on longer term metrics. All sectors of the market registered positive returns during April but there was a wide variation. The Financials sector only just registered a positive return at 0.17%, compared with Energy +10.81%, Materials + 7.64%, Healthcare +7.44%, and Consumer Staples, +5.77%. Excluding Financials, other underperforming sectors included Telecommunications, Utilities, and I.T. The smaller end of the market increased at a slower pace, rising 2.75%.

The Banking, Superannuation and Financial Services Royal Commission was again a feature of news headlines through April, with AMP and CBA experiencing the worst of it in relation to customer treatment. Governance failures and, indeed, lies to ASIC and interference in relation to an "independent" report by Clayton Utz have seen management and board member departures from AMP, with likely more to come. The turmoil extends to its adviser network, with reports of departures and enquiries around reputational concerns in being aligned to AMP. The findings to date, and, in particular the impact upon the AMP business, highlight the extent to which governance, honesty and integrity, or lack of them, can impact upon the wellbeing of a business. It may be sometimes forgotten, but the most important stakeholders in any business are satisfied customers. Without them the concept of sustainable and growing shareholder returns is impossible. AMP is not held in any of our managed portfolios, nor has it been for several years.

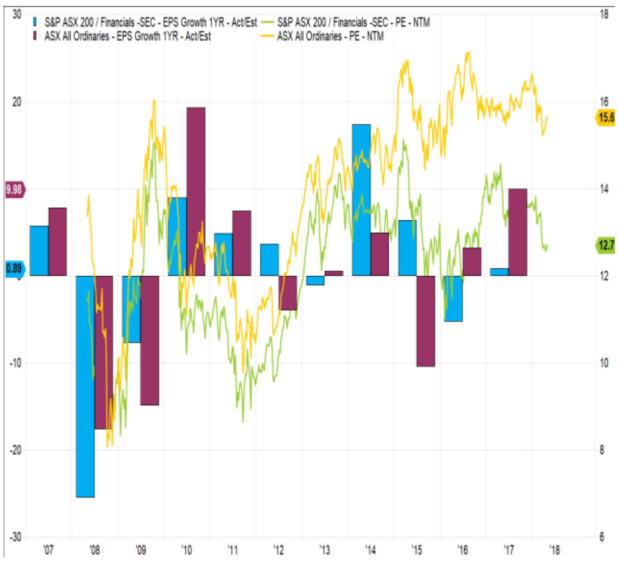
Having rallied around 5% in March, energy prices rallied a further 5-7% in April, extending the recovery in oil and energy prices in excess of two years. Prices have improved from around US$30/bbl in 2015 to be around US$70/bbl currently. The consensus 12-month forward ASX All Ordinaries Price to Earnings multiple, based on *Factset* consensus data, rose from 15.2x to 15.6x at the end of April. Market pricing at 15.6x continues to look reasonable given forecast market growth (*Factset* data) of 9-10% for CY18. The Health Care and Materials sectors are at the high end of growth forecast at 15% and 13% respectively. The Telecommunications sector sits at the low end at -2%, while the Financials sector is forecast to grow around 5%. In the context of a relatively low multiple and high fully franked yield, the Financials sector is starting to look attractive, despite the turmoil caused by the Royal Commission.

Chart of the Month – The Financials Sector

This month we feature the Australian Financials sector and compare its relative valuation against the broader market. In the chart we show the Financials sector 12-month forward PER alongside the ASX All Ordinaries 12-month forward PER. It highlights the disparity that has opened up between the Financials Sector and the ASX All Ordinaries. We also show earnings growth for each index.

The PER difference gap began to open up through 2015, as it became apparent earnings growth for the banking sector in 2016 and 2017 would lag the market. This was a function of slower credit growth and a regulatory requirement for banks to recapitalise their balance sheets.

The gap began to close in late 2016, but has opened up again since mid-2017, on weaker earnings growth, and more recently on the Royal Commission findings. We had held a bearish view on the Financials sector but recently neutralised this position on valuation relativity. While EPS growth may continue to lag the market, the franked yield is attractive.



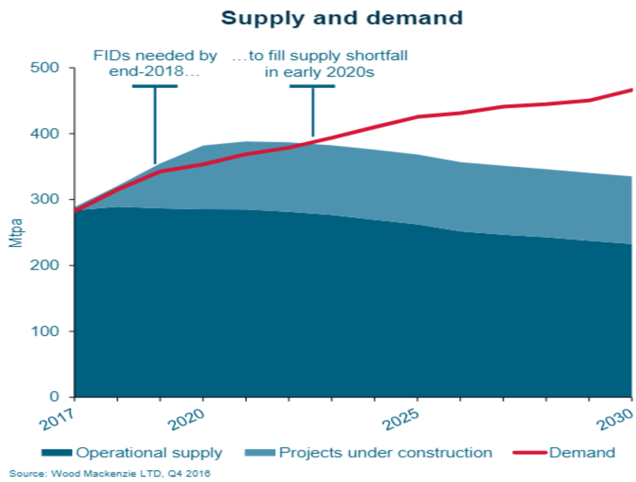
Due Diligence – *A closer look at a stock of interest*

Woodside Petroleum (WPL)

We added Woodside Petroleum to our larger portfolios during the early part of April – to gain some direct exposure to the energy sector – complementing the exposure that is held through our holdings in BHP. In conjunction with a tightening LNG market, Woodside's recent purchase of ExxonMobile's 50% stake in the Scarborough field, improves the company's medium term growth outlook. With the acquisition, Woodside moves to 75% ownership of Scarborough.

Woodside intends to develop Scarborough through an expansion of the Pluto facility, lifting production from 4.7Mtpa to around 5.5Mtpa from 2021 and to 8.0Mtpa by 2025. Woodside is now in an attractive position, with their oil equivalent production levels forecast to rise by 14% from FY17 through to FY20, and growth is set to continue from the Pluto/Scarborough development through to FY25.

LNG Market Dynamics



With stronger oil prices, WPL benefits both from its direct oil exposure and from its oil linked gas contracts. WPL is not an expensive business, trading at PER multiples around 15x CY18 and CY19, ahead of growth from FY20. In addition, it is a high yield payer at 5%+ fully franked. Given its circa 80% payout ratio, Woodside is unlikely to expand its dividend payments until growth begins to accelerate in FY21. Consensus earnings estimates, based on *Factset* data, have earnings per share in the order of A$2.10 in CY18 and CY19, with $2.30 forecast for CY19 and around $2.65 in CY21.

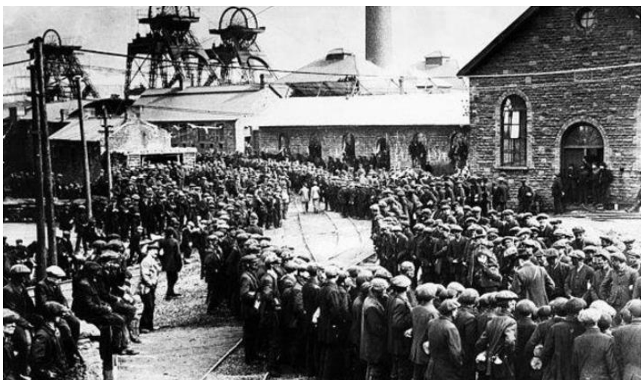
THE ENERGY MARKET, ELECTRIC VEHICLES & THE FUTURE FOR OIL

The LNG market is attractively balanced with forecasts suggesting up to 16Mtpa of new capacity required annually to meet demand. Emerging buyers are fuelling demand; enabled by new technologies, emission restrictions, and China's five year plan – China has a reduced outlook for its own domestic gas supply and an increased forecast for gas imports. There is also some optimism around the strong oil cycle continuing. We are not suggesting that oil prices will necessarily rally much higher on a sustainable basis, but oil may well hold current levels for some time. There are, in fact, several supporting factors.

The forward curve for oil has not been supportive of investment in the oil sector for some time, limiting the potential for new supply. The forward curve for oil has traded at about US$50-55/bbl two to three years out, a price level that makes it difficult to justify new conventional greenfield exploration. In addition short cycle US shale has the capacity to plug gaps when conventional supply can't meet demand. If this is the case then it is hard to see support for oil prices moving much beyond current levels on a sustainable basis but prices could easily hold. The perception of the Electric Vehicle (EV) threat may also continue to dampen the forward oil curve, although we don't see it as a major risk to oil prices. There is a view however that EV growth, battery technology, and the rise of renewable energy have the potential to impact longer term oil prices. Despite weak oil prices for the past several years, interest in the renewables sector has not waned. Reducing emissions in urban areas is not just an issue of global conservation but also one of local health. Regulation is likely to force a greener environment in many regions.

However, conventional global vehicle growth continues at a rapid pace such that the absolute increase in conventional vehicles is likely to rise for some time before EV growth sends it the other way. Perhaps a more likely scenario is that hybrid vehicles initiate the ultimate reversal in vehicle-based oil demand, given hybrid vehicles do not have the range limitations of EVs.

An important factor to consider is that oil is a 35-40% cleaner fuel than coal. So if EVs continue to grow for environmental and health reasons, by the same reasoning, it makes far greater sense to eliminate coal usage and substitute it with other fuels. What this essentially means is that, before oil can become a defunct fuel, coal needs to get there first. As coal is phased out there will be greater demands on all other fuel sources, including oil, for the primary purpose of replacing coal as an energy and heating fuel. So even if oil is not to be the fuel of choice for transportation vehicles at some point, it may well form part of coal's replacement before then.



Forward-thinking striking coal miners resume work after negotiating landmark pay-package comprising combination of Bitcoins and Tesla shares…