JM Financial Group

Issue 35: March 2018

Investment Newsletter

Performance *(As at 31st March 2018)*	Month (%)	Rolling 3mths (%)	Rolling 1yr (%)	Rolling 3yrs (%)	Inception (%)
JMFG Australian Equities Strategy	**-3.59%**	**-2.80%**	**+6.44%**	**+26.59%**	**+44.13%**
All Ords Accumulation Index	-3.55%	-3.69%	+3.65%	+13.88%	+28.74%
Outperformance	**-0.04%**	**+0.89%**	**+2.79%**	**+12.71%**	**+15.39%**

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 March*

Led by the US market, the All Ordinaries Accumulation Index fell 3.55% in March. By comparison, the S&P 500 Index in the US fell 2.54%. The weaker markets were a direct response to US President, Donald Trump's declaration, that he will impose tariffs on steel and aluminium imports, of 25% and 10% respectively. A number of nations including Australia have been given exemptions. An ongoing trade war with China and other trading nations would have a dampening impact on global growth. For the March quarter the All Ordinaries Accumulation Index fell 3.69%, compared with the S&P 500, down a modest 0.76%. The ASX Small Ordinaries Accumulation Index fell 2.3% for the month of March.

Financials experienced one of the largest sector declines of the month, falling 5.1%. The start of the Banking, Superannuation and Financial Services Royal Commission saw a number of new misconduct cases exposed, including bribery of NAB Bank Managers, failures to certify loan income and expense documentation and various other incidents. Once again the Telecommunications sector was the worst performer, falling 6.1%. It has now fallen 37% since June 2016. The Materials sector fell 4.3%, driven by Rio, -7.8%, and BHP, -5.3%. The only sector to show a positive return in March was Property Trusts, which rose 0.1%. Sectors that experienced moderate falls included many of the lower growth yield sectors: Utilities, -0.8%, Industrials, -1.1% (includes Transurban, Sydney Airports and Macquarie Atlas Roads), and Consumer Staples -1.7%. Surprisingly the I.T. sector only fell 1.6% for the month.

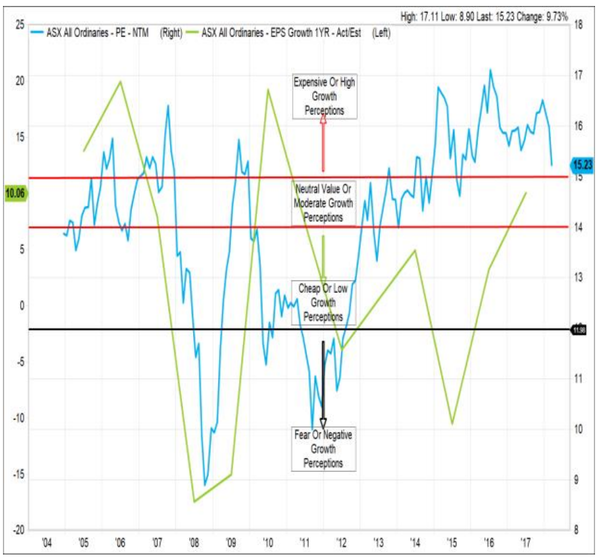
US dollar commodity prices generally weakened through the month, with iron ore prices 10-20% lower and base metal prices around 5% lower. However energy prices rallied around 5% and gold was stable. The consensus 12-month forward ASX All Ordinaries Price to Earnings multiple, based on Factset consensus data, fell from 16.1x at the end of February 2018 to 15.2x at the end of March 2018. The decline would be a function of the market decline over the month, rolling the 12 month earnings growth forward one month, and potentially some minor upgrades to earnings across the material based businesses, given the ongoing strength of commodity prices relative to expectation generally. Market pricing at 15.2x now looks reasonable given a moderate growth environment is expected. Multiples below 14x in a moderate growth environment would be considered cheap.

Chart of the Month – 12 Month Forward PER & Earnings Growth

We often talk about the 12 month forward PER, and use it as a reference point, to help determine market value. The multiple alone does not indicate value, but rather the combination of the multiple and earnings growth expectations.

There was an aberration in the relationship in 2015, when the earnings decline was not matched by a reduction in the forward 12 month PER. This occurred, as the decline was very much isolated to the materials and energy space, and was significant, with iron ore and oil prices both falling by about 60% between June 2015 and December 2015. The broader market in fact continued to experience solid earnings growth, and as such the earnings decline in materials/energy had a distorting impact on total market growth.

If earnings growth of 5% is achieved over the coming 12 months, the forward PER should drop to around 14.4x. In a low interest rate environment, the combination of mid-single digit eps growth and a 12 month forward PER sub 15x looks reasonable.



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

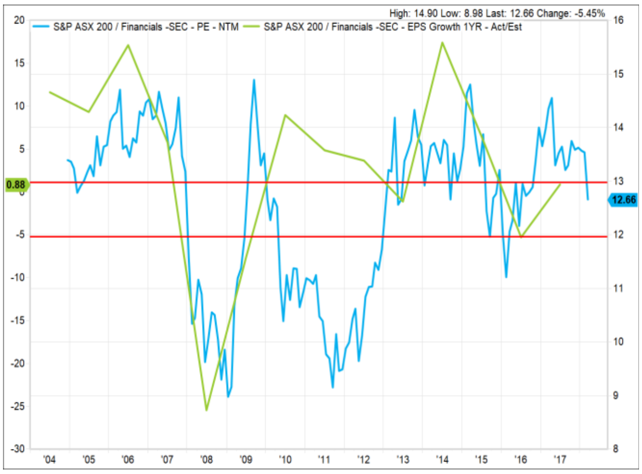
The Major Banks (CBA, NAB, ANZ, WBC)

The Financial Sector 12 month forward PER has moderated from above 14.5x in early 2017 to around 12.6x currently. This looks to be a very reasonable level, so long as earnings growth re-emerges over the next twelve months. We expect this will happen, so long as any Royal Commission findings do not have an overly onerous impact on underlying earnings growth.

Historically the major banks have traded at multiples in the 13-14x range, when underlying 12 month forward earnings growth has been between 3-7%. The market appears to be pricing the banking sector for ongoing earnings declines.

We expect bank earnings growth to be moderate at only 2-4% over the coming twelve months but in combination with high dividend payouts we expect total returns in the order of 10% should help to drive the sector.

FINANCIAL SECTOR VALUE



Dividend yields over the past 12 months, for each of the major banks, were between 6.0% (CBA and ANZ) and 7.0% (NAB) with Westpac at 6.6%. So long as the banks do not experience earnings declines, we would expect some PER multiple appreciation, or at the very worst stable PERs for the sector over the next 12 months. Should the Labor government win office at the next Federal election, and reduce franking benefits, there could be some shift of funds away from the high yielding banking sector, toward slightly lower yielding businesses with higher growth prospects - Transurban potentially. Any shift however is likely to be at the margin only and short lived.

TRADE RESTRICTIONS AND TIT FOR TAT

During March U.S. President Trump announced a 25% tariff on steel imports, and 10% on aluminium imports. However a range of nations were given exemptions, including Australia. More trade and more exports, typically equates to more jobs – introducing tariffs has the opposite effect. Introducing tariffs can be used to protect local inefficient production and jobs, but in all likelihood results in an equivalent or worse impact elsewhere in an economy. Tariffs raise the prices of product, which flows onto consumers through higher inflation. Higher priced goods means less spending power, and hence either a reduction in production elsewhere in an economy, or a reduction of other imported product. So while Trump's actions may win votes from some constituents, he is likely to lose votes elsewhere.

Any tit for tat retaliation could have a far more detrimental impact. Should China impose similar restrictions back on the USA, the impact upon the USA could easily be a net loss of jobs. Recently, China announced tariffs on 128 US products, including wine, pork and steel pipe. Trump has threatened to put protective duties on up to US$60b of other Chinese products. There have been suggestions that China could in turn impose tariffs on other agricultural product, including soy beans, apples etc. While any tariff war can only result in lower global growth, some trading nations could be net beneficiaries. Australia might in fact be in such a beneficial position. Given the exemptions Australia has been given on steel and aluminium, and as a major producer of those products, and the inputs that go into them, along with our agricultural production, it is possible that Australia is not detrimentally affected.

The net result may well be a reduction in overall global production and consumption, but for Australia, that could be offset by our capacity to replace the goods that would otherwise have been traded between the USA and China.

There is however a deeper downside to all of this, and that is, if Trump does not get the desired effect, by imposing tariffs on select countries and products, he may extend tariffs onto many other products and other countries. Whilst a completely illogical thing to do, Trump beats to his own drum, and is highly unpredictable. Nothing is beyond reason.

From a market perspective, none of this is good, even if Australia is not economically affected. A trade war will have a negative effect on other economies, which in turn will affect sentiment and market valuations. The Australian markets would most likely get caught in the crossfitre.

Nothing better than a good old fashioned trade war