JM Financial Group

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Investment Newsletter

Performance *(As at 30th September 2018)*	Month (%)	Rolling 3mths (%)	Rolling 1yr (%)	Rolling 3yrs (%)	Inception (%)
JMFG Leaders Strategy	**-1.81**	**+1.47**	**+14.28**	**+39.96**	**+43.13**
ASX 200 Accumulation Index	-1.26	+1.53	+13.97	+40.91	+39.62
Outperformance	**-0.55**	**-0.06**	**+0.31**	**-0.95**	**+3.51**

Although the JMFG Leaders 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 September*

JMFG's Australian Leaders Strategy fell 1.81% for the month, marginally underperforming, by 0.55%, the ASX All Ordinaries Accum. Index which fell 1.26%. For the 12 months, JMFG's Leaders Strategy is up 14.28%, marginally ahead of its benchmark. The strongest sectors of the market in September included Energy +4.3%, Materials +4.2%, and Telecommunications +2.7%. Weakest sectors included Healthcare -8.0%, easing after a near 50% increase over the 12 months to end August 2018, Consumer Discretionary -4.2%, and Utilities -3.3%.

Two stocks were removed from the portfolio in the month and no new stocks were added. Janus Henderson was cut from the portfolio early in the month, following another quarterly net outflow reported in August – the June 18 quarter net outflow was US$2.7b. Eight of the last nine quarters have experienced net outflows, a concerning trend. We also sold our position in Suncorp mid-month on concerns around findings from the Royal Commission into Banking, with the insurance sector in the spotlight through September. The cash holding at month end was 6.7%.

The stronger performers for the portfolio during the month included:

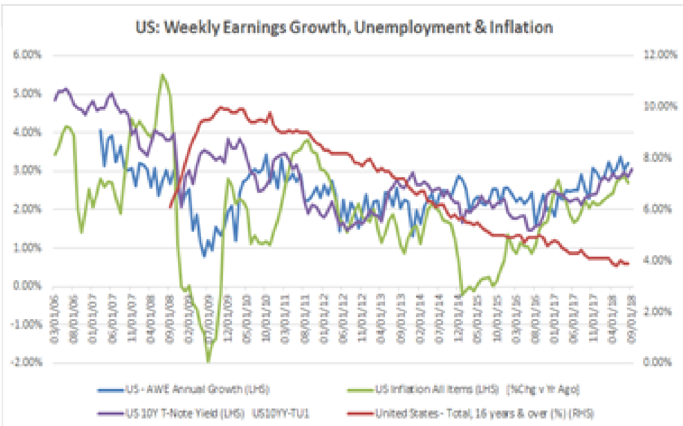
- South32 +12.6%, Rio Tinto +8.3%, and Woodside Petroleum +4.6%

The weaker performers for the portfolio during the month included:

- CSL -11.5%, Treasury Wine Estates -10.2%, and Webjet -9.2%

While the ASX All Ords Accum. moderated only slightly in September, its 12-month forward PER eased from 16.3x to 16.0x indicating earnings forecasts held firm post reporting season, with a small net upgrade of around 1%. Commodity prices were generally firm, with energy prices rising around 5% over the month. Copper and zinc increased 2-3%, having experienced sizeable drops over recent months, and iron ore also strengthened around 3%. Nickel and lead were weaker, declining 3-4% and continuing their weak trends experienced over recent months. Base metals over the past 6 months are 15-20% lower than their peak levels.

Chart of the Month – Interest Rates & Valuations



Economic growth in the U.S. has accelerated through 2018, with current estimates for Real GDP growth at 2.9%, up from 2.2% in 2017. Improved economic growth in the U.S. has seen unemployment levels fall to under 4% (Total for 16 years and over). Unsurprisingly, average weekly earnings annual growth has pushed above 3%, having averaged 2% or less for most of the five year period from 2012 to 2017. Inflation has moved from a sub 2% range to 2.7-2.8% over recent months and yields on longer-term treasury notes has pushed up to around 3%. All of these factors have led to a strong US$.

While economic strength drives earnings growth, there is a danger point where that economic strength drives interest rates to a level where the valuation impact of higher interest rates more than offsets the positive impact of earnings growth. Growth for now is at healthy levels and interest rates are by no means stretched. Market multiples however are on the high side – the S&P 500 trading at close to 17x its forward 12-month PER. The US markets are generally priced for ongoing consistent growth and moderate interest rates. This may continue to be the case for some time, but rising tariff regimes present a left-field risk which is difficult to quantify. Any significant tariff intervention is likely to have direct consequences upon economic growth, inflation, overall risk and ultimately interest rates. How these all combine and affect market valuation is impossible to quantify, but unlikely to be positive.

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

Cochlear (COH)

Cochlear is another great Australian success story within the healthcare space. Dr Graeme Clark was inspired by the close relationship he had with his deaf father, to begin research into an electronic hearing device implantable directly into the cochlea. From the first cochlear implant recipient in 1978, the company partnered with Nucleus to further develop implant technology and launch its first commercial implant device in 1982. US FDA approval was received in 1985 for implants for adults. The first two paediatric implant recipients occurred in 1985/86 at the Royal Victorian Eye and Ear hospital. US FDA approval for children was obtained in 1990. By 1994, the 10,000th recipient was celebrated and Cochlear made its ASX debut in 1995.

Dr Graeme Clark, 1970

Digitisation and miniaturisation has seen development accelerate since 1995. Today, the company is a global enterprise with a market capitalisation in excess of $11b, generating $1.35b revenue in FY18 and $348m EBIT. It is projected to generate $1.5b revenue in FY19 and $380m EBIT.

Today's cochlear implants are an effective solution for people with moderate to profound hearing loss, while bone conduction implants are a suitable alternative for people with conductive hearing loss, mixed hearing loss and single-sided deafness. Ongoing development of products and accessories, as well as opening up of new markets throughout both developed and developing nations, provides a strong platform for growth to continue well into the future.

Borrowing Rates & Cash Rates

The US Fed Funds Target Rate (yellow line), the rate at which banks in the U.S. can borrow from the Federal Reserve, has been rising since late CY15 and now sits at 2-2.25%, well above the RBA's long-held cash rate (magenta line) of 1.50%. This historically has been an irregular occurrence. The US Fed Funds Target Rate has been at or above the RBA's cash rate for all of 2018. The last time it achieved this status was 1999 through to 2000.

The gap between the US 30-Year Treasury Bond Yield (blue line) and the Fed Funds Target Rate is the smallest it has been since 2007, when both were around 5%. The current funding environment in the US has had a direct impact on the US dollar, which has seen the A$ decline in comparison. This has created quite an unusual situation for Australia, particularly given the recent strength in major commodity exports – iron ore, coal, and buoyant soft commodities – all of which are priced in US$. Our export values have been rising, supporting ongoing trade surpluses as well as helping to reduce government budget deficits through royalties.

Against a backdrop of low unemployment and a strong economy, how much longer the RBA can keep cash rates at 1.5%, below the current inflation rate, is likely to become a greater topic of debate. With house prices finally easing across Sydney and Melbourne, after years of increase, that factor has become less of a reason for the RBA to raise rates. Inflation may well be the major risk, but for now, in Australia, that continues to be in the low 2% range. The market is generally of the view that the RBA cash rate will be on hold until the middle or latter part of 2019, which if correct should continue to be supportive of Australia's equity markets. If there is a risk, it may well be U.S. inflation. Should that break through the 3% range (2.8% current), further interest rate increases in the U.S. would be likely and, in turn, lead to a stronger US$. The flow-through effect of a stronger US$ would most likely lead to rising inflationary pressure in Australia and a possible increase in the RBA cash rate. For now, that still seems some way off.