JM Financial Group

Issue 47: March 2019

Investment Newsletter

Performance *(As at 31st March 2019)*	Month (%)	Rolling 3mths (%)	Rolling 1yr (%)	Rolling 3yrs (%)	Inception (%)
JMFG Australian Equities Strategy	**-0.74**	**+5.71**	**+2.47**	**+25.07**	**+47.75**
All Ords Accumulation Index	0.70	+11.06	+11.25	+37.78	+43.22
Outperformance	**-1.44**	**-5.35**	**-8.78**	**-12.71**	**+4.53**

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) and taxes. Strategy Inception for Performance Data is July 1st 2014.

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

JMFG's Australian Equities Strategy decreased slightly by 0.74% through March, underperforming the ASX All Ordinaries Accumulation Index which rose slightly by 0.7% for the month. The best performing sectors for the month were Property Trusts +6.2%, Telecommunications 4.0%, and Consumer Staples 3.9%. The weakest sectors were Energy -4.1%, Financials -2.7%, and Utilities +1.3%.

We added two new stocks to the portfolio – Nearmap and FlexiGroup. Nearmap is an aerial satellite imagery provider which recently announced record growth in annualised contract value from its US operations. We increased our position in St Barbara on price weakness, and Appen through a capital raising, and reduced our holdings in Adairs, Bapcor, and GUD Holdings due to continuing subdued market conditions.

St Barbara, a long-term contributor to the Australian Equities Strategy, had its first blemish during March, reporting a reduction in expected gold production at its Gwalia Deeps mine. This event, plus unexpected falls in some other holdings recently, has contributed to recent underperformance by the strategy. We are hopeful of a turnaround in performance in the current quarter. The portfolio cash holding at month-end was 7%.

The stronger performers for the portfolio during the month included:

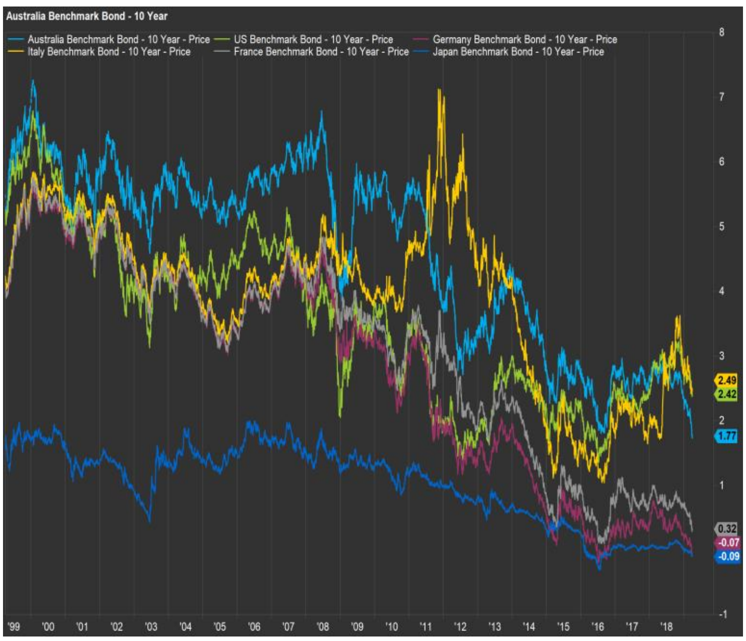
- Medical Developments International +21%, AfterPay Touch Group +14%, and The Citadel Group +9%

The weaker performers for the portfolio during the month included:

- St Barbara -25%, Webster -9%, and Bapcor -9%

The ASX All Ords' multi-month rally extended further through March, although at a more subdued pace, its 12-month forward PER remains around 15.7x, which is expensive compared to its long-term average.

Chart/Table of the Month – Global Interest Rate Reversals



When we last wrote about 10-year interest rates in our monthly newsletters, in May 2018, rates were generally in a rising trend, from lows reached in mid-2016. Interest rates continued to rise through to October 2018, but since then, they have been in decline across major economies as well as Australia. Having peaked in the US above 3.2%, the US 10-year benchmark rate is around 2.5%. Similar rates across France, Germany, and Japan are negligible and at the same time the Australian 10-year benchmark rate has declined from 2.8% to 1.8%.

Since October 2018, a number of major economies have experienced a slowdown in economic growth. European Union real GDP growth has moderated from 1.9% to 1.4% compared with the year prior, with CPI declining from 2.2% to 1.6%. Real growth rates in Japan, the United Kingdom and the U.S. have moderated real GDP growth only by about 0.1%, but in each case, CPI has moderated by 60-100 basis points over the year.

The impact on equity markets has been greater demand for higher yielding companies as well as demand for higher quality growth assets.

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

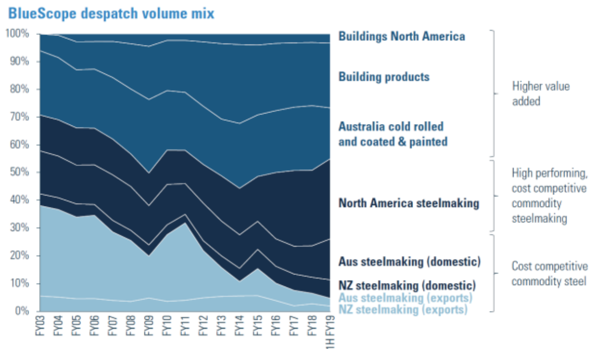
BlueScope Steel (BSL)

BlueScope is readily recognised for its premium branded coated and painted steel products, and is ranked the third largest manufacturer in this category of steel products globally. The company has come a long way from the 2011-2012 period where it posted in excess of $1.5billion in losses across the two years, due to restructuring costs and severely weakened trading conditions, as construction demand tapered off sharply.

Subsequent austerity measures, reinventing its brand focus toward higher value-add steelmaking and engineered building products, and strengthening its presence in North America were evidently steps on the right path for BlueScope, ultimately returning to profitability last year with underlying net profit after tax of $826m and underlying EBITDA of $1.65bn reported for FY2018. The company is already on track to exceed that this year with a half-year EBITDA figure of $1.06bn reported for the December half. Continuing growth is being supported by higher steel prices across all segments and weakening Australian vs US dollar exchange rates.

BlueScope operates five business segments:
North Star – Ohio-based mill producing hot rolled coil for automotive, construction and manufacturing;
Buildings North America – supplies Engineered Building Solutions to local and regional industry and commerce;
Australian Steel Products – the country's only flat steel producer, makes the familiar Colorbond, Zincalume, and Lysaght branded steel products;
New Zealand and Pacific Steel – NZ's only steel producer, making branded flat and long products for domestic and Pacific region markets; and
Building Products Asia and North America – produces metal coated and painted steel products in joint venture partnerships with Nippon Steel and Sumitomo Metal Corp for the Asia-Pacific region, in a JV with Tata Steel to cover India, and directly in China through wholly owned subsidiaries.

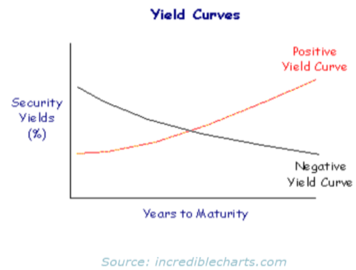
BlueScope's Change in Product Focus over 16 years



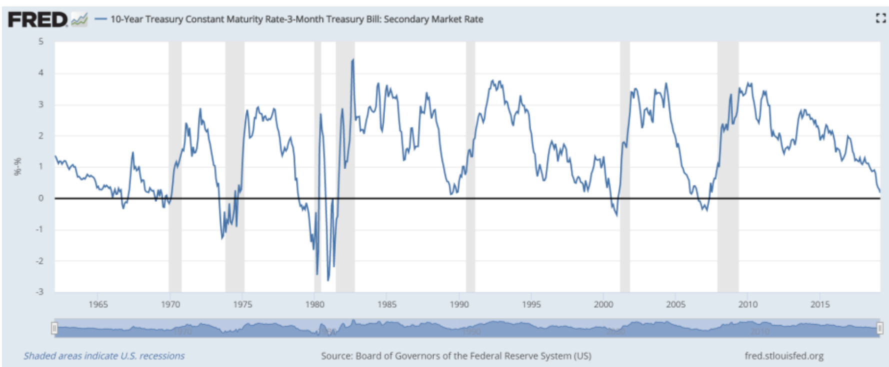
The *despatch volume mix* chart shows BlueScope's focus shifted over the past eight years away from Aust/NZ steelmaking towards North American steel and building products; a strategy that has paid off well so far.

US TREASURY BOND YIELD INVERSION

An inverted yield-curve occurs when short-term Treasury bonds are offered at a higher yield than long-term bonds. Effectively, the market is taking a bearish view on the economy into the future, and therefore has an expectation of a future reduction in cash rates. The nearer a short-term bond is to maturity, the closer it should trade to the cash rate, as the cash rate becomes a more comparable alternative investment. Historically, a bond yield-curve inversion in the US has preceded a recession on six out of the past seven occasions, with an average lead time of 16 months. In 1996, economics researchers Mishkin and Estrella, based on the smaller data set available at that time, implied a 25-30% likelihood of a recession within 12 months, and the subsequent two inversion/recession events upheld their hypothesis and demonstrated the correlation could be even higher.



However, improvements in monetary policy in the past decade, along with a broader international flattening of yield-curves across developed economies may support an exception this time. Accordingly the US Federal Reserve is expected to cut short its planned five years of interest rate increases in order to stimulate economic activity in the near future.



By comparison, the equivalent inverted yield trigger for Australia has not proved to be a useful indicator of a recession eventuating here. While the 3-month bank bill yields are also currently higher than 10-year Government bond yields, this inversion has happened six times since the GFC and no Australian recession has yet manifested within a year of any inversions. While vigilance is always warranted, conclusions about correlations from small data sets should be considered with extra caution.