fatPROPHETS™

2019 Review

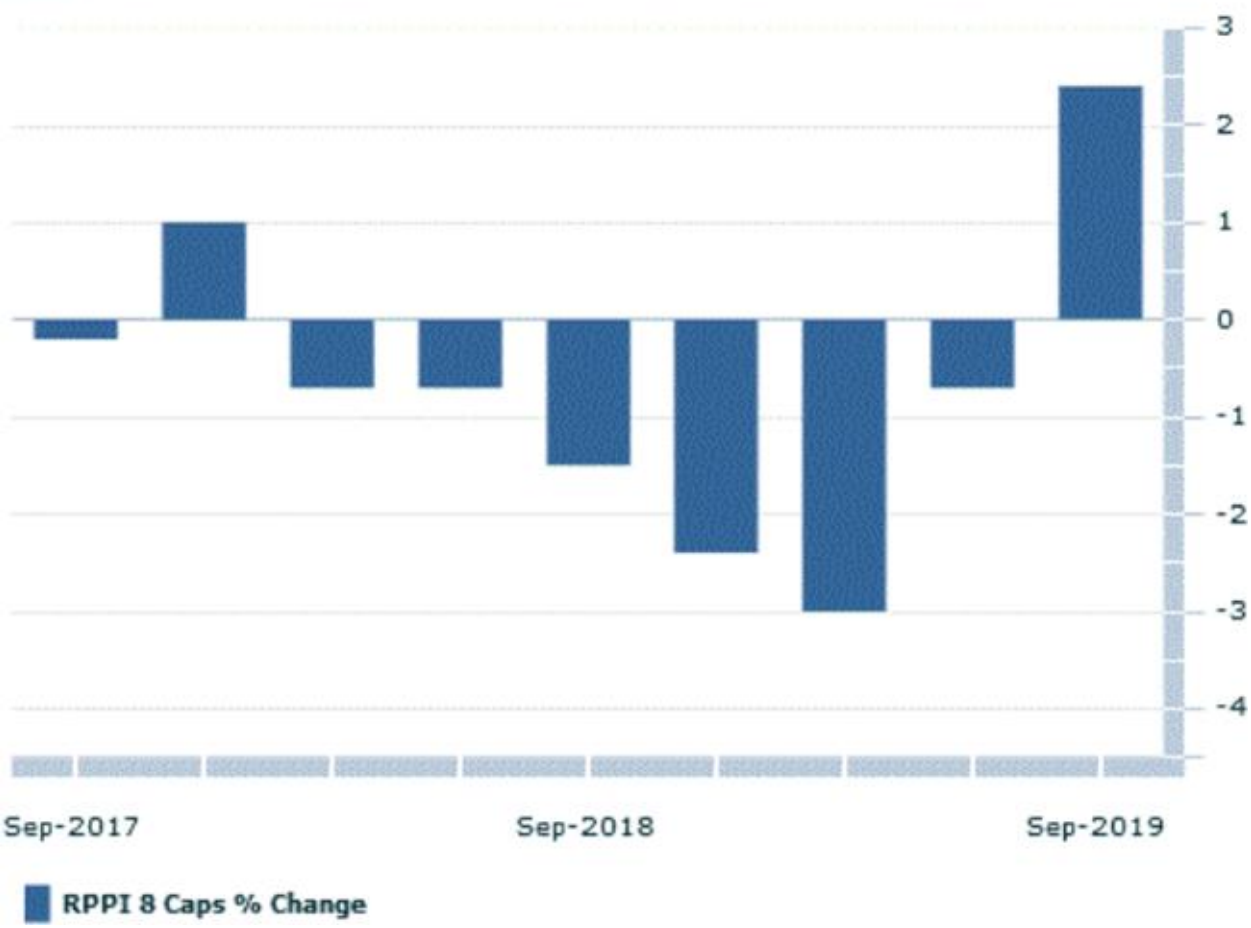
December 17, 2019 FAT-AUS-951

Climbing the "wall of worry"

Markets this year have had plenty to 'worry' about this year, and particularly after coming off a tumultuous quarter just under 12 months ago. Domestically, a big concern for investors was the short-term economic and market impact of a Labor government winning the Federal election in May. In the end those fears turned to relief, with the Coalition not only staying in power, but rolling out a sustained fiscal stimulus package in the form of tax cuts and a major infrastructure roll-out plan.

Concerns also abounded about the state of Australia's housing market, with many going so far as to predict a 'crash,' with the rating agencies also effectively putting our economy 'on watch,' as a result. Our belief that these fears were off the mark looks to have proven well founded, with the property market springing into life in recent months, helped by three, 25 basis points, rate cuts by the RBA. The impact of the ongoing, and devastating drought has also been a factor for consideration.

Residential Property Prices, Weighted average of eight capital cities, Quarterly percentage change



Source: ABS

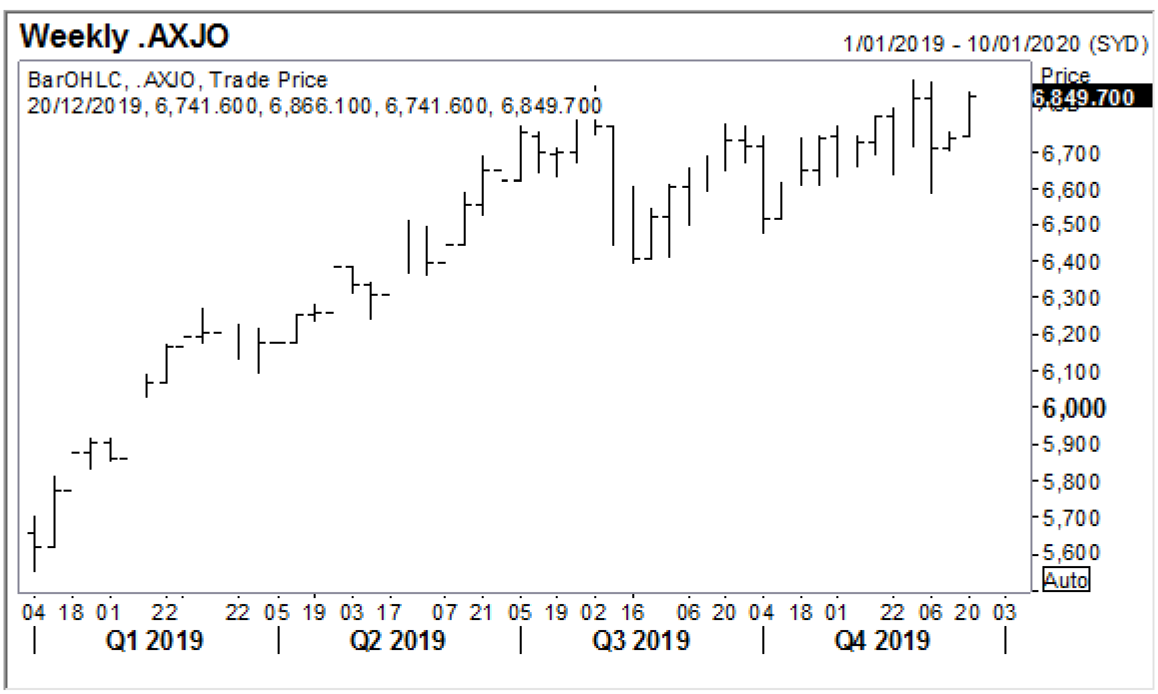
On the international front, trade has dominated as the key risk, and particularly given the consequent economic impact to China, our largest trading partner. The perils if an escalating trade war were also heavily reinforced in monetary policy commentary from the RBA. Markets pushed on nonetheless, with investor optimism well founded given last week's Phase One agreement between the US and China.

Not everything has of course been 'beer and skittles,' not least of which the banking sector, which has continued to suffer in the wake of the fallout from the Royal Commission, compounded by the recent 'transgression' by Westpac. This has seen some management 'fall on their swords,' while capital raisings and dividend trims have also been a feature. Net interest margins have also been under pressure, although, the rebound in the housing market is a reason to be optimistic, as we head into 2020.

An even lower interest rate environment has also reinforced the appeal of the high yielding Australian market, with a subdued currency also helping to engineer M&A activity by offshore predators. A corporate sector in a reasonable (albeit cautious) state has also provided a tailwind to stocks.

In the end this has seen the ASX200 enjoy a very positive year in 2019, adding almost 1200 points, for a 21% gain year to date, as things stand. The pre-GFC all-time highs were also eclipsed. <u>Our view that, following the election result and an outcome on trade, that the index may push towards 7000 by the end of the year, may also not prove too far off the mark.</u>

ASX200



<u>A key issue influencing Australia, and markets globally, in 2019 was the US-China trade war</u>, with investors hanging on commentary about trade talk progress, on an almost daily

basis. Given the substantial influence of both the world's largest and second-largest economies on the global economy and trade, the prospects of a prolonged dangerous trade war had investors on edge. Hopes swung back and forth between optimism and pessimism throughout the year, as tariffs were either imposed by the US, or at times delayed. While global equities moved in either direction based on commentary and actions related to the trade war, overall stocks generally grinded higher during the year. Brexit was also a major topic, although less relevant for Australian investors in the bigger picture.

With fresh tariffs on about $160 billion of Chinese goods due to go into effect on December 15th, the past weekend was an important one. Positively for markets, the US and China announced they had reached a "phase one" trade deal on Friday, 13 December. Not only will the new tariffs not be imposed, the agreement will see the US reduce some tariffs on Chinese goods in exchange for China increasing purchases of US agricultural, energy and manufactured products by approximately $200 billion over the next two years.

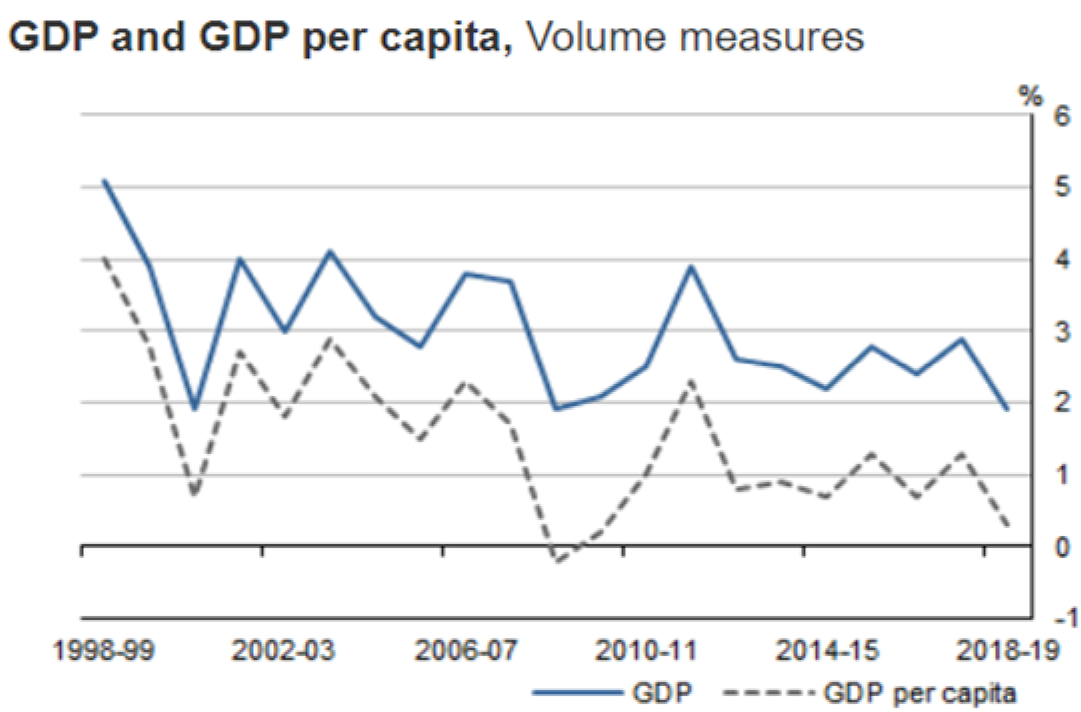
China has also said it will better protect US intellectual property rights, which was a key sticking point in the negotiations. China also pledged to open its financial market to US firms and avoid manipulation of its currency. Earlier in the year, the US accused China of manipulating the yuan to make it more competitive, which blunted the impact of tariffs.

The phase one agreement still requires the need for text revisions, and to be finalised in that respect, but the markets have accepted that after many previous snags when a deal was near, this time around it is effectively a done deal.

Besides US-China trade, central banks (the RBA included) have continued to be a key influence for financial markets in 2019. Most influential, globally, was the US Federal Reserve's rate-cutting cycle, which boosted investor sentiment by signalling the central bank would do whatever it could to prevent a recession, after a record long, albeit not particularly strong, expansion. The Fed (like the RBA) cut the benchmark rate three times over the course of the year. Besides providing support for businesses at home, this also served to contain the strength of the US dollar, which generally hurts emerging market businesses and economies. The flip side was weakness in the A$, a positive for our exporters and economy generally.

Other central banks also provided support during the year, with the European Central Bank (ECB) moving back to a QE (quantitative easing) policy again, as Mario Draghi's swansong, and China's central bank taking a series of small steps to support its slowing economy.

In many ways Australia stayed the 'lucky' country, with fiscal 2019/20 marking the 28th consecutive year of economic growth. The export market and government spending have been tailwinds, as has population growth. However, on the other side, on a per capita basis, growth at 0.3% is at its lowest since 2009/10.



Source: ABS

September quarter growth came in at a modest 0.4%, but was at least an improvement on the previous three months. We believe that with trade frictions subsiding, and a number of domestic stimulus initiatives pushing through, we could see further economic momentum in calendar 2020. This would also be positive for the ASX200 and market generally, and particularly given our key benchmark is not expensive versus many offshore peers.

Portfolio movements in 2019

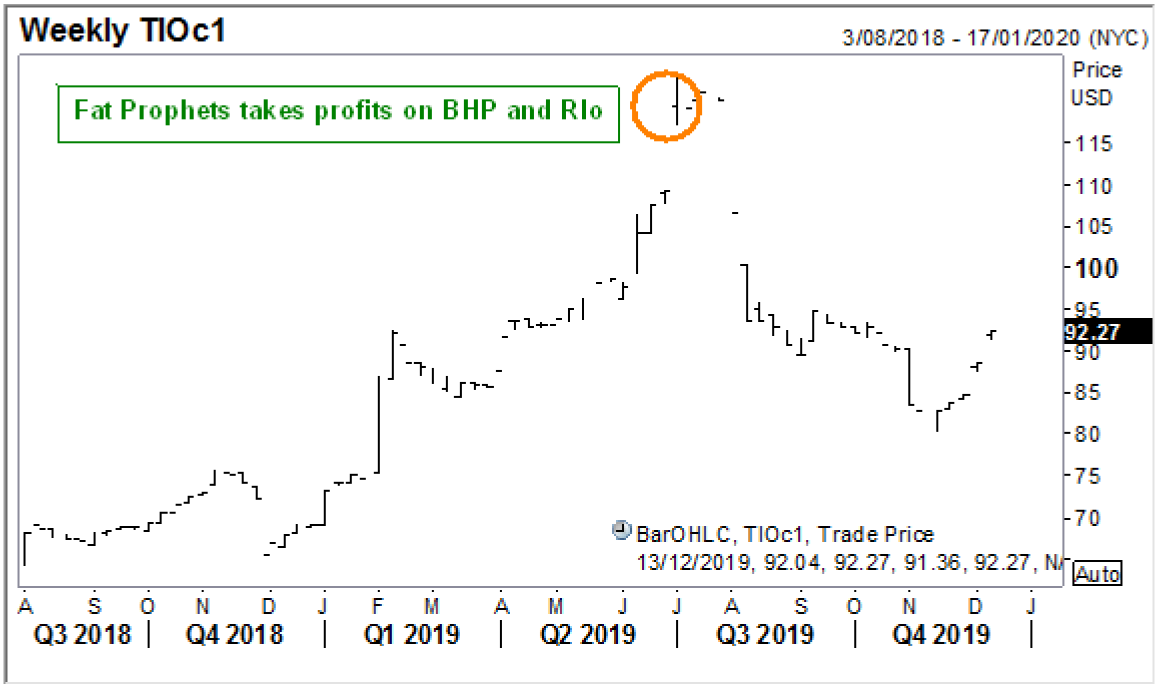
We remained mindful of the need for prudent portfolio management during the year, and particularly as volatility remained present, locally. We initiated sell or 'sell half' recommendations 8 times in the Fat Prophets Australasian Equities Portfolio over the year, with gains having been reported on 7. The lower level of sell recommendations than in 2018 reflected what we found were relatively undemanding valuations for Australasian stocks.

We have discussed the reasons for taking profits or losses on these stocks in a separate report (refer to the report titled 'Where we took Profits and losses in 2019'). Needless to say, that in each instance, the decision to sell-half or all of each position was consistent with our adherence to the principles of fundamental value investing with a technical overlay.

One of our more significant calls was to take profits off the table on diversified mining behemoths **BHP** and **Rio.** The stocks have been stalwarts in the portfolio, but we believed that iron ore prices had become overextended, and with supplies coming back from Vale's mines (which were impacted by a second dam disaster in January.)

We have been bullish on iron ore prices, and even through 2018 and into 2019, when many investment banks were calling prices down towards US$50 a tonne. **Our decision to call 'the peak in iron ore' at US$125,** also ironically coincided with many instos becoming much more optimistic about pricing.

We issued 'sell halves" on BHP and Rio in July, as we believed iron ore prices were peaking



We were also active in telcoms, issuing a 'sell-half' on **Vocus** after the company received a takeover approach. The prudence proved well justified, with two bidders walking away in quick succession. We have since reverted back to a buy on the stock.

On the subject of takeovers, the foray of **Bellamy's** into the portfolio proved relatively short, after the infant milk play received an approach from China Mengiu Dairy Company. With the deal done, Members who followed the recommendation will have generated a total return of around 28% or more.

For a review of our other sell and sell-half recommendations please see our separately issued report.

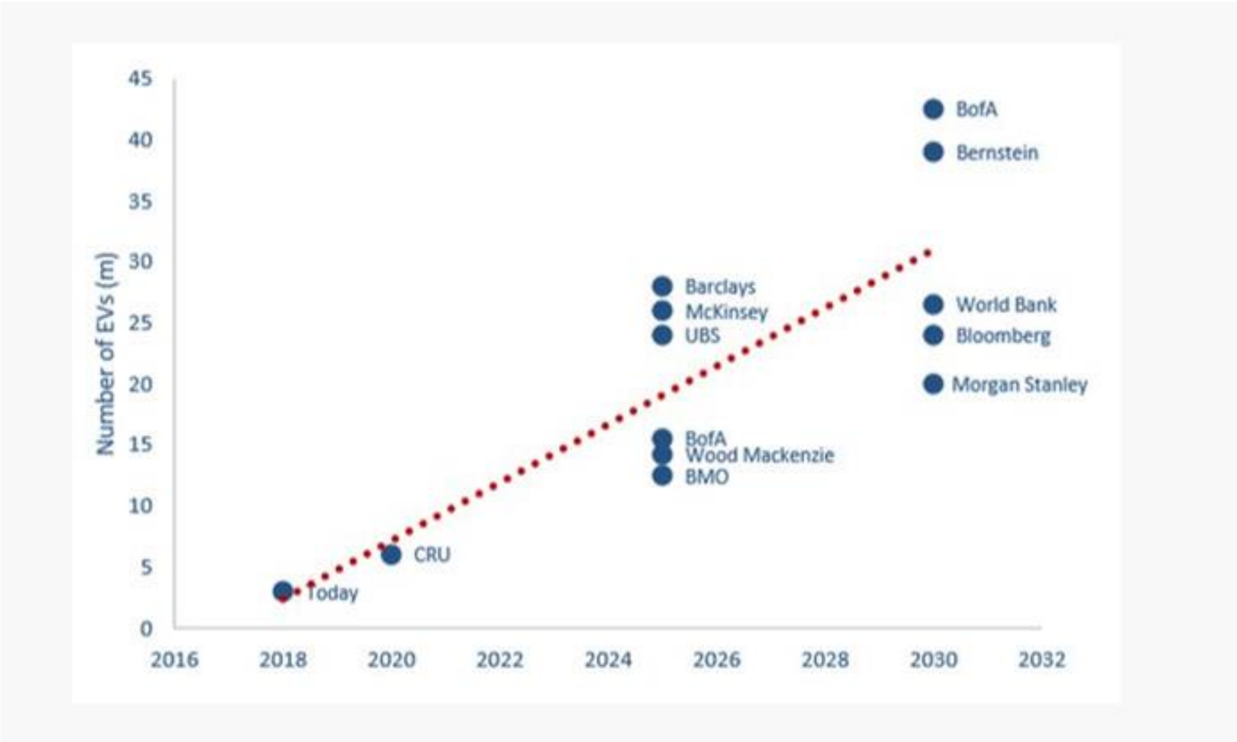
New recommendations

In addition to **Bellamy's**, there were 8 other new entrants to the Fat Prophets portfolio this year, the majority of which were thematically driven.

Included here was nickel producer **Western Areas.** Nickel prices exploded to the upside in late August with investor focus on further supply side pressures, as major producer Indonesia announced a ban on exports from the end of 2019. This is against the backdrop of rising demand for nickel, and a major sea-change in the automobile industry, which is starting to phase out carbon-based combustion power-plants, with electric vehicles to the fore.

We see the multi-year bear market in nickel as having terminated, and see Western Areas as high quality, pure play, nickel miner, with a strong operational track record, which was further evidenced by recent FY19 results.

It is agreed amongst forecasters that the auto industry will undergo a change from producing internal combustion engine vehicles (ICEV) to producing electric vehicles (EV). The quantum of EV's forecast to be produced is varied, but importantly the trajectory is upward. The following chart shows EV production forecasts and a best fit trendline:



While early days, our recommending the stock looks to have been reasonably well timed. And this is also as M&A activity in the space appears to be on the rise.

Our view that a Coalition election victory would spur a raft of activity for the infrastructure space was behind our recommendations of **Decmil Group** and **SRG Global.** Neither have yet to perform, with delays in the spending rollout one headwind. We remain positive on both companies and see better times ahead for both in 2020.

The same can be said of **Boral** in our view, and despite the recent profit warning from the company. We see the construction sector domestically turning back up, and in line with renewed house price strength. The fact that peer James Hardie (also in the portfolio) has been hitting record highs speaks to the durability of the US market, where Boral also has exposure.

Sentiment towards **National Storage REIT** has picked up since it entered the portfolio a few months ago. We believe NSR to be a high-quality exposure in the self-storage sector.

NSR has weathered a soft property market in resilient fashion, and has also continued to expand through acquisition. With real estate now in the throes of turning around, we believe this bodes well for NSR's future earnings growth profile, and with the REIT having a high degree of operating leverage.

On the subject of operating leverage, we continue to favour the financial service platform stocks. To this end, we added **Mainstream**, a stock we remain very positive towards. The company has been executing well, with strong inflows, and is on track for a medium-term target of $100 million in annual revenues.

Our decision to welcome **Westpac** back into the fold has not proven timely, given recent events. We still see a rebounding property market as one tailwind, although the bank clearly has some issues to navigate. A senior management clear-out is, however one step in the road to repairing investor confidence.

More recently, we have added Australian, now global master franchisee, **Domino's Pizza Enterprises** to the mix. The shares have endured a rough time since peaking in August 2016, although appear to have turned a corner in the last three months.

We believe the growth outlook for the company has improved significantly across all of the company's key markets in Europe, Japan and Australia. France will provide significant upside and is set to open a record number of new stores in FY2020, which will be underpinned by a rejuvenated franchise network. Japan is going from strength to strength, with customer and sales growth, while in Australia, sales momentum is rebuilding, which should underpin a jump in margins next year.

We provided updates on the **Fat Prophets 'Income Portfolio'** each quarter, and the income yield since inception in March 2012 to 2nd December 2019, stands at 25.8%, which is in addition to the capital growth of 16.4%. This makes for a total return of 41.4% since the portfolio was constructed in March 2012.

Overall, we remain comfortable with the performance of the Fat Prophets Income Portfolio, noting that to date it has delivered on its mandate. That is to construct and maintain a concentrated basket of stable, well-managed, and financially sound companies that distribute strong, sustainable and defensive income streams.

Looking at the research portfolio more broadly, performance-wise, the Australasian equities report continues to track well. This is also a reflection of the fact we generally get it right more often than we get it wrong (and raise our hands when we don't.) The annualised return since inception on the Australasian Equities Report was 18.8% as at 31 October 2019, versus 8.4% for the All Ords over the comparable period.

The feedback from Members

If the results from our Member Survey for 2019 are any indication, our stock recommendations, in combination with the enhancements that we have introduced to our service in recent years, continue to be appreciated.

The daily email from Angus Geddes is a vital part of our communication with Members and a channel through which Fat Prophets provides clarity on our views on macro and micro-economic developments, and the implication for stock markets, in a timely manner. Consistent with our top-down and somewhat contrarian approach to stock selection, analysis of global events impacting markets featured prominently again in 2019.

The daily email was separately graded, and received a 'B+' once again, which is a testament to the value placed on it by many Members.

Our efforts on the Australian Equities research service have been awarded an 'A' grade from Members for 2019, which is in line with what we received last year.

Our weekly research webinars continue to be well received. These sessions give Members the chance to hear direct from our Head of Research Greg Smith, of our view on market events and developments. The forum style with a Q&A session at the end has also been a great way for us to engage with Members and the feedback here continues to be positive.

Members also remain receptive towards our weekly fatWRAP which summarises the ideas from across the Fat Prophets suite of research products. We continue to put plenty of thought into our covers and design, so it is pleasing that feedback here remains positive.

We look forward to striving to further improve our offering for Members in the coming year.

Until next year

We will be publishing our predictions for 2020 in the next report to be published on the 7th January 2020. As usual, these predictions will cover a range of topics.

Signing off on 2019 (and another decade!), we would like to once again thank all Members for their continued support, and wish all a safe and happy Christmas and a prosperous New Year.

Best regards,

Fat Prophets

Disclosure: Interests associated with Fat Prophets hold shares in BHP, Rio, Western Areas, Domino's Pizza Enterprises, Vocus, Westpac, Mainstream, National Storage REIT

Dutch Shell, Simon Property Group Inc, Swire Properties, THK Co. Ltd, UMH Properties Inc, Vornado Realty Trust, Yaskawa Electric Corporation These may change without notice and should not be taken as recommendations.