Morphic
Asset Management

HALF YEAR REPORT

January - June

2019

Global Responsible Investors

TABLE OF CONTENTS

MORPHIC ASSET MANAGEMENT TEAM

Jack Lowenstein, Chad Slater, Geoff Wood, James Tayler

Irene Kardasis, Nadeem Ali, Claudia Kwan, Lucina Martin,

Kelsey Bentley, Kevin Zheng, Eva Trabaud

MESSAGE FROM JACK LOWENSTEIN

Jack Lowenstein

Joint Chief Investment Officer

Dear Investor,

The storm clouds of 2018 parted as quickly as they seemed to come, with the first half of 2019 delivering excellent returns to equity investors as the fears of 2018 receded into the distance, replaced by the soothing balm of talk of interest rate cuts around the world. This saw markets rally 16.6% in the first half of 2019, with the US market making new all-time highs. Yet we have lingering concerns the storm of 2018 was the prelude to more bad weather, not an Indian summer.

The first half of 2019 has also been a momentous year for Morphic as a company. In June, Ellerston Capital acquired the majority of the Morphic business, with the team moving into the Ellerston offices. Ellerston is one of Australia's largest boutique asset managers, with over $5bn of assets and 60 investment professionals across more than 12 investment strategies.

Why the partnership? It enables the investment team to focus more on what they love – investing. The Morphic team gains access to Ellerston's wider analyst pool and support infrastructure and we improve our reach to investors whose aim is to build wealth by following the principles of responsible investing. The Morphic brand will remain intact, a recognition of the brand awareness that the team has built within ethical and long/short investing.

We look forward to updating many of you face-to-face in November during our next semi-annual pan-Australian roadshow when we will introduce more of the Ellerston team. Our May-June briefings concluded our series of briefings around Australia which saw nearly 300 people attend across seven cities. For those who would like to watch the Sydney briefing, a video recording is available on our website. Chad Slater also spent a week in Europe meeting investors in April. With the recent Australian elections there has been heightened interest in what Australia is going to do to meet its climate action goals.

On a personal level, I would also like to thank our former Morphic chairman Nick Minogue and directors Gerard Minack and Chuak Chan, who left the board after the merger, for all their wise counsel over the last seven years.

Turning to the team, some staff will be leaving Morphic. Cameron Halkett has left to enjoy a well-deserved break in Europe before pursuing a role on the sell-side. Eva Trabaud who is responsible for the beautifully designed and presented report you are reading is also leaving. She is a passionate believer in ESG and ethical investing and we wish her all the best breaking down the ESG barriers in Hong Kong.

Kind regards,

Jack Lowenstein

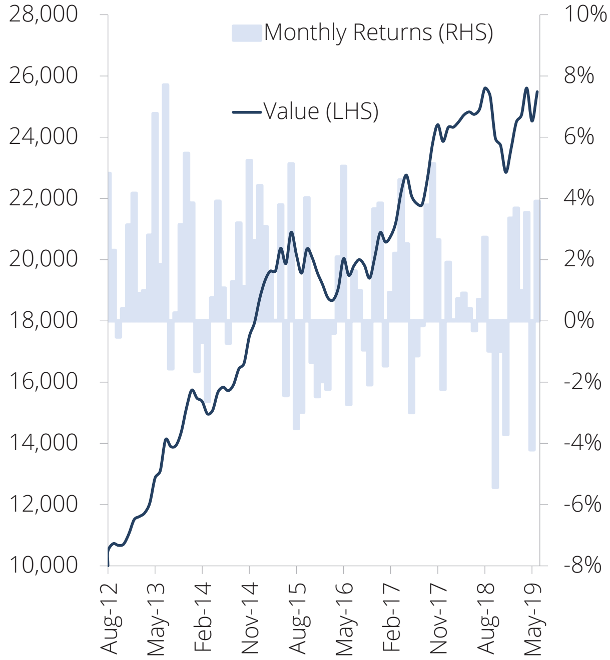
MORPHIC GLOBAL OPPORTUNITIES FUND UPDATE

CERTIFIED BY RIAA

INVESTMENT RETURNS[1]

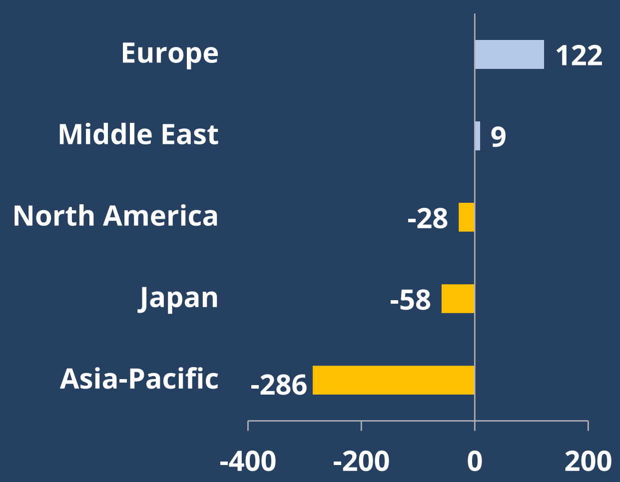
	MGOF	Index[2]
3 Months	3.1%	4.9%
6 Months	11.5%	16.6%
1 Year	3.0%	11.3%
3 Years p.a.	9.4%	13.9%
ITD p.a.	14.5%	16.4%

PERFORMANCE OF AUD $10,000



Past performance is not an indication of future performance.

6-MONTH EQUITY ALPHA BY REGION



TOP ALPHA CONTRIBUTORS OVER THE LAST SIX MONTHS[3]

- **Panalpina** 108 bps
- ***Qantas*** *29 bps*
- ***Iida*** *29 bps*

TOP ALPHA DETRACTORS OVER THE LAST SIX MONTHS[3]

- **China Water Affairs Group** -61 bps
- **IRB Infrastructure** -60 bps
- **YES Bank** -57 bps

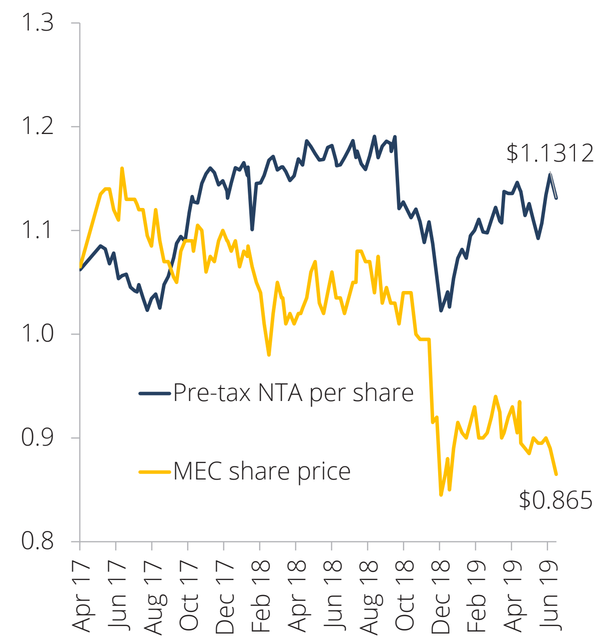
[1] As at June 2019; [2] The Index is the MSCI All Countries World Daily Total Return Net Index (Bloomberg code NDUEACWF) in AUD;
[3] Attribution; relative returns against the Index excluding the effect of hedges. Past performance is not indicative of future performance.

MORPHIC ETHICAL EQUITIES FUND UPDATE

INVESTMENT RETURNS[1]

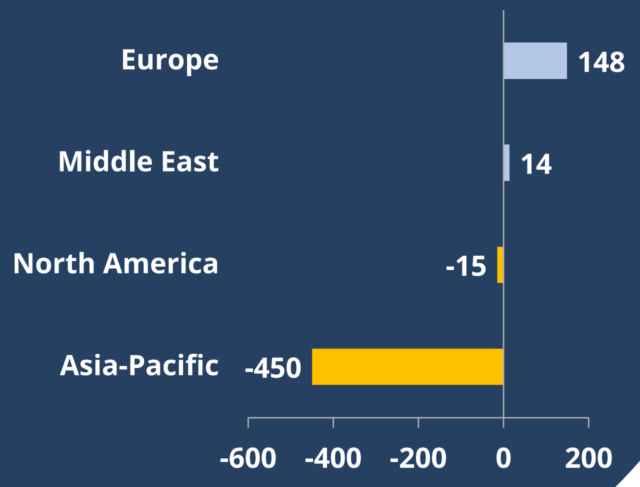
	MEC	Index[2]
3 Months	2.3%	4.9%
6 Months	10.0%	16.6%
1 year	2.7%	11.3%
ITD p.a.	6.2%	12.2%

MEC SHARE PRICE VS NTA[3]



Past performance is not an indication of future performance.

6-MONTH EQUITY ALPHA BY REGION



TOP ALPHA CONTRIBUTORS OVER THE LAST SIX MONTHS[4]

- **Panalpina** 114 bps
- ***Iida*** *48 bps*
- **Kion Group** 44 bps

TOP ALPHA DETRACTORS OVER THE LAST SIX MONTHS[4]

- **YES Bank** -86 bps
- **IRB Infrastructure** -86 bps
- **China Water Affairs Group** -62 bps

[1] As at June 2019; performance is net of investment management fees, before company admin costs and taxes; [2] The Index is the MSCI All Countries World Daily Total Return Net Index (Bloomberg code NDUEACWF) in AUD; [3] Net Tangible Asset Value before tax, in AUD, between May 2017 and June 2019; the figures are unaudited; [4] Attribution; relative returns against the Index excluding the effect of hedges. Past performance is not indicative of future performance.

REFLECTIONS ON THE HALF

"See, I have the advantage of having found out how hard it is to get to really know something, how careful you have to be about checking the experiments, how easy it is to make mistakes and fool yourself. I know what it really means to know something… and I can't believe that they know it."

Richard Feynman, American Physicist, on the false delusion of confidence

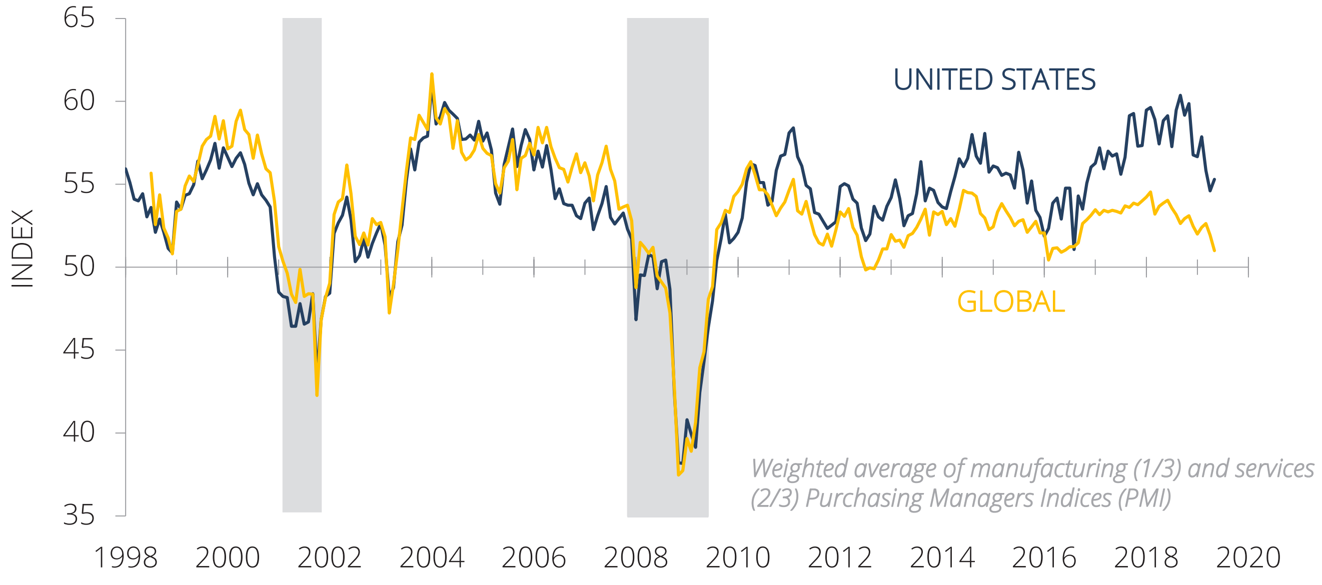
Reviewing the prior Half Year Report ahead of writing a new one always makes for interesting reading. Where you were right, where you were wrong, and what you never saw coming. One of the hardest things about markets is the balancing act between being humble in the face of being wrong, lest the market humiliates you and your investors, and actually believing the market may be wrong. This doesn't get any easier with time.

The second half of 2018 had been particularly challenging for markets and the Morphic view of markets. Re-reading our report, it is apparent that we were genuinely perplexed as to the extent of the sell-off last year and argued that our fundamental decision-making process was not flawed in our assessment of upside/ downside risks.

In that respect, to sit here with markets having recouped all their losses of late last year and the US market to be within 1% of its all-time highs is a vindication of the assessments made and analysed in 2018. Morphic has great respect for the above quote by the eminent scientist Richard Feynman, about the false delusion of confidence which can sometimes be costly.

The first half of 2019 was characterised by weaker growth and weaker data globally (**Figure 1**), but equity markets have interpreted this as "Goldilocks". The porridge that is the earnings and interest rates that feed markets is neither too hot (growing so fast that interest rates rise), nor too cold (interest rates are falling, but the economy is going into recession).

Figure 1 – Purchasing Managers Indices



Source: Minack Advisors

Morphic has written in a number of blogs that decelerating economic data and good equity returns can be happy bedfellows for some time. The result of this combination is that "everyone is a winner": bond owners benefit as interest rates fall and equities rise as well (**Figure 2**).

Geopolitics returned again, as has been the increasing case since the election of Trump. Over the half, tariffs were raised or threatened to be raised against Mexico, China, Europe and Japan. Australia narrowly escaped a list that seems destined to include most US trading partners.

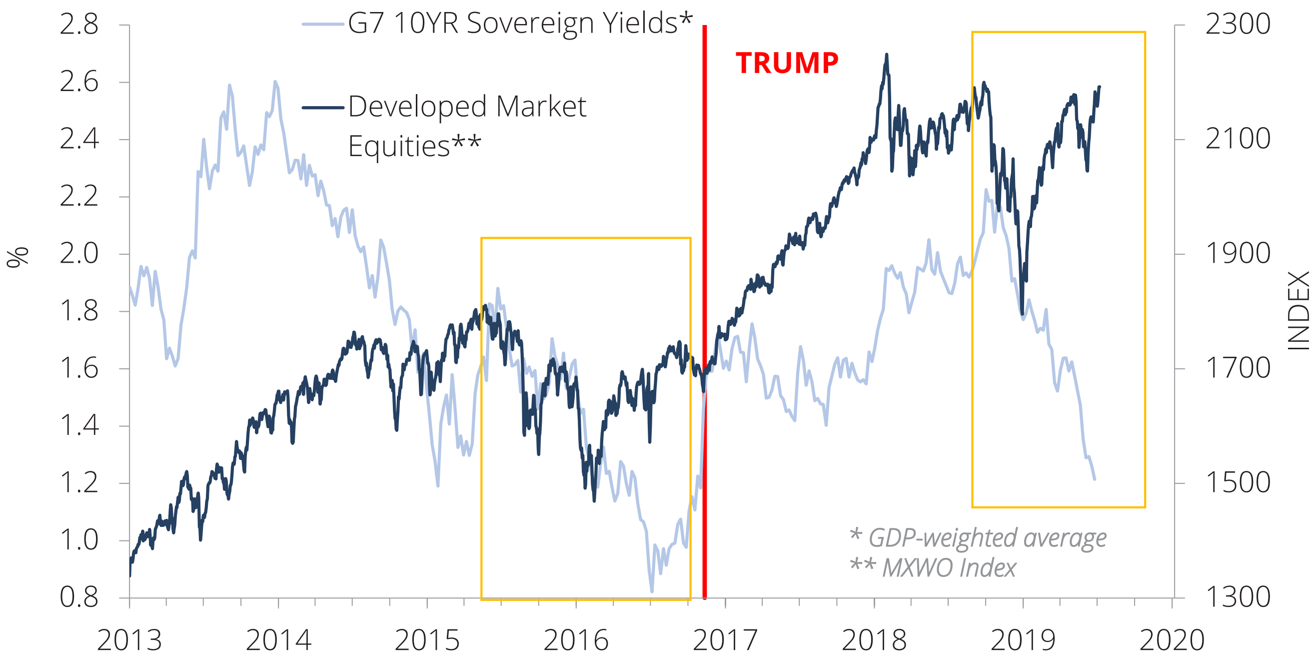
Additionally, the US Federal Reserve Bank did a volte-face, reversing its position on guiding to rate hikes and inserting the wording of "patient" to indicate a willingness to wait and see. Indeed, it now appears the market expects it to cut – and cut aggressively – in the second half of the year. We will provide further thoughts on this in the Outlook section.

Morphic had anticipated that with lower expectations of interest rate increases in the US, money would flow into markets outside the US. This was not the case. One of the usual pressure release valves for Emerging Markets – a lower US Dollar – did not happen.

Whether it is correlation or causality, not only did Emerging Markets economic data suffer relative to the US, Emerging Markets also underperformed the S&P 500. The economic data remained particularly soft in China but notably also spread to Japan which saw increasing downgrades to the earnings outlook, making Japan a laggard to many equity markets over the half.

Against this backdrop, the Morphic Global Opportunities Fund rose 11.5% and the Morphic Ethical Equities Fund 10.0%, lagging global markets which rose 16.6%. Stock selection and portfolio exposure to regions outside of the US were the main causes of the lagging performance. Of note, the short positions detracted minimally despite the stronger up market. Hedging was a small detractor as the Funds carried more cash over the half, reflective of our cautiously optimistic stance after 2018.

Figure 2 – Developed Markets equities and 10 Year G7 Sovereign Yields



Source: Minack Advisors

The largest positive contributor over the half was our long position in **Panalpina (PWTN SW)** after it accepted a takeover bid from DSV. In the last Half Year Report, we spoke at length about this being one of our newly initiated positions and why we thought governance was about to improve. Even in our more optimistic mindset, we didn't think the stock would be bid for in such a short period. It wasn't without drama though, and this is where the Morphic approach of "active engagement" can help outcomes. The board was initially reluctant to accept the offer and even considered using shareholder funds to pursue a poison pill style acquisition. Morphic worked with the Swiss regulator and press to call this out and bring together shareholders to oppose it.

The other large contributor of note was our short position in **Iida Holdings (3291 JT)**. The stock fell heavily over the half as fears of a housing slowdown in Japan accelerated, culminating in the stock downgrading earnings in late May. We have exited the short, but will look to re-enter if the stock rallies too far.

India was our unhappiest hunting ground, providing four of our five biggest detractors. By far the worst – and the biggest disappointment - was **YES Bank (YES IN)** which we had seen as an oversold turnaround story.

Until 2018, YES had been one of India's best performing banks. Then it was pummelled as the Reserve Bank of India (RBI) forced the company's founder and Managing Director (MD) out of the business because of what it claimed were governance deficiencies, high-risk lending, and inadequate recognition of bad loans. As the clouds seemed to be clearing and the stock rose with the appointment of a well-regarded external candidate as new MD, and much better than expected RBI inspection report, YES became one of our highest conviction positions.

However, the final act of what we expected to be YES's recovery failed to play out as the new MD used his first quarterly reporting to issue a completely unexpected condemnation of the bank's culture, organisational form and asset quality, and announced an expensive and high-risk restructuring. We exited immediately, as the stock fell nearly 40%. It has since fallen another 40%.

Turning to new ideas entering the portfolio, we would like to focus on one of the new names that are coming from the Ellerston Global Equities team, who we are now working closely with. One of their holdings is **Kurita Water (6370 JT)**. Kurita is a leading provider of water filtration and purification in the world. Trading on 14x P/E, it is the cheapest it has been in seven years and fits the Morphic ESG Funds mandate well.

WE INVEST IN COMPANIES THAT MAKE A DIFFERENCE

ALSTOM

GLOBAL LEADER IN RAIL TRANSPORT

+10% REVENUE INCREASE

VS

-13% ENERGY CONSUMPTION DECREASE (OPERATIONS)

IN FY 2018/19

CHINA EVERBRIGHT INTERNATIONAL

ENVIRONMENTAL RESOURCE MANAGEMENT

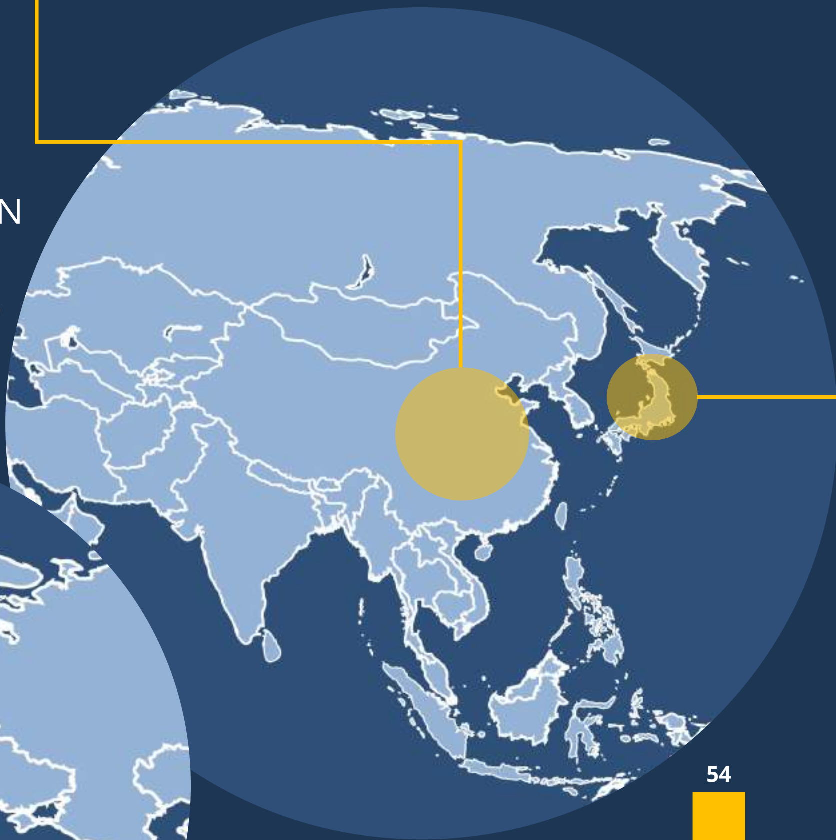
8,294,419,000 kWH

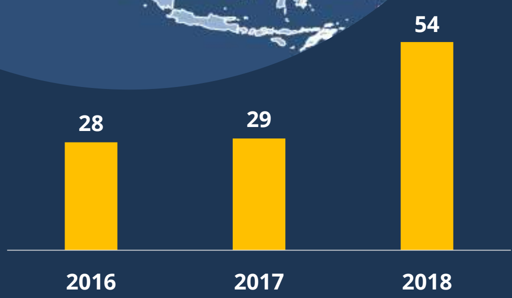
GREEN ELECTRICTIY SUPPLIED

10,811,827 T OF CO_2

EQUIVALENT EMISSIONS OFFSET

IN 2018





WATER SAVINGS (MILLION M^3)

WATER TREATMENT LEADER

KURITA WATER

SPECIAL FOCUS: TWO PARADOXES AND A KEEPCUP

"Where are they?"[1]

Enrico Fermi, Italian Physicist

"The hush of the night sky is the silence of a graveyard."

Ted Chiang, American Sci-Fi writer, *The Great Silence*

For the Special Topic section this half, we felt it was timely to remind readers just what "we are fighting for"; why the Funds they have invested in do not own coal and other hydrocarbons, and why we short-sell these stocks when appropriate. But also, why we think this is not some far away topic that affects other people in another time. It is timely because we are reminded of its importance by a recent UN report on the 6th biggest mass extinction that is underway. A mass extinction initiated and visited upon the world by humans.

In the book *"The Gap: The Science of What Separates Us From Other Animals"* by Thomas Suddendorf, it is argued that what makes us human and separates the "great apes" from other species is not the ability to speak or build a fire, rather it is our imagination and our friends with imaginations (the power of connected groups). Our imagination empowers us to envision things that currently do not exist. This enabled us to envision the coming winter well before it arrives and plan for it; to plan and coordinate with others. This imagination forms the basis of what we now call intelligence, with, somewhat unfortunately, imagination being relegated to childhood.

When it comes to the climate emergency, "climate change" does not do justice to what awaits us. Humans are blessed (cursed?) with this ability to see and imagine the coming destruction we have wrought. Because no matter how bad you think it is and how much you have read about it, you lack imagination: it is much worse.

The changes predicted ten years or more ago are occurring now and if the current path of rising emissions holds, life will be intolerable for billions within the lifetime of our children.

It is often forgotten that 1.5-2°C of global warming is a baseline model and not a "worst case" outcome and yet this scenario will still see Jakarta and Miami disappear! If we consider the upper bounds of modelling, 5°C of warming is not improbable. "No action" would create positive feedback loops whereby melting permafrost releases methane and oceans burp up hydrogen sulphide – the little known murderous culprit in prior extinctions.

1 https://en.wikipedia.org/wiki/Fermi_paradox - *Fermi's name is linked because of a casual conversation in the summer of 1950 with fellow physicists Edward Teller, Herbert York, and Emil Konopinski. While walking to lunch, the men discussed recent UFO reports and the possibility of faster-than-light travel. The conversation moved on to other topics, until during lunch Fermi suddenly said, "Where are they?" Two of his three lunch companions remember immediately knowing that Fermi was referring to potential extraterrestrials. Furthermore, York remembers that Fermi "followed up with a series of calculations on the probability of earthlike planets, the probability of life given an earth, the probability of humans given life, the likely rise and duration of high technology, and so on. He concluded on the basis of such calculations that we ought to have been visited long ago and many times over."*

This could lead to the disappearance of 90% of species within three generations. Pause for a second and think about both the magnitude and the immediacy of this paragraph.

This article is not enough to describe the horrors that await. If you want to read more, and we urge you to rather than avert your eyes, this NY Mag article, whilst 18 months old, is a good place to start for a general introduction to terror.

So why the lack of urgency? This is the first paradox: we can see the future and we can stop it, and yet instead of "preparing for winter", we are either frozen in indecision or denial.

There is no doubt there has been a surge in responsible investing in recent years. This is by no means a bad thing and should be applauded. But it seems that society, having surveyed the difficulty of the problem, reached the conclusion that buying a KeepCup is the best we can do. Now, don't get us wrong, we like and we use our KeepCups – but this idea that a few small changes will suffice is doing a disservice to scale of the emergency we face.

We see this reaction across industries: witness fashion week in Australia in partnership with their "(frank) green cup". According to McKinsey, 3/5ths of all clothing ends up in landfill and the industry is responsible for 10% of global carbon emissions. Instead, we get a green cup and very little change in the process of fast and disposable fashion. We ask again: why the lack of urgency?

There is a similar KeepCup narrative in our industry, that funds can become "ESG/ethically compliant" with minimal changes to their investment process and no risks to future returns. Of course, many investors love this narrative of feeling good and yet changing very little. Consider this: one large fund which is presented and sold as ESG aware, has half its assets in "high risk" areas, assets that will be worthless if one is to model the impact of 4°C of warming on sea levels. Do those investors realise their superannuation is in potentially worthless assets?

Then there are the challenges of "allocating pain". The recent election in Australia highlighted the challenges we face in deciding who is to bear the pain of change. Conservative Queenslanders were lectured by a life-long unionist from a state that plays the wrong football, that they should lose their jobs for a goal that seems to have many downsides for them whilst those lecturing bear no immediate pain. The predictable answer they gave consisted of two words: F you.

Neither KeepCups nor lecturing will move Australia forward. "Border pricing of Carbon" in Australia would mean the burden is shared more equally – the UK has reduced its carbon emissions by 40% with carbon pricing yet has less than 4% unemployment. Rather than blockading mines, this approach taxes the consumption of carbon and starts an adult conversation about how to look after the workers who lose out. Undoubtedly, Queensland does have a lot to lose from the climate emergency but you won't win an argument on the climate emergency without offering something in the way of jobs.

Which brings me to the second paradox: sadly, we may be solving the Fermi paradox – the first of the two paradoxes in the title. Fermi famously asked why, given there are thousands of planets that can support life, is the universe so silent? The answer may be that intelligent life creates ever increasing ecological disasters in its evolution, leaving only a few short years of transmitted data to be found by another civilisation in a matching short period, making the combination highly improbable.

Our imagination got us here and, we hope, it can get us away from where we are going.

OUTLOOK

"It's supposed to be hard. If it were easy, everyone would do it."

Tom Hanks, *A League of Their Own*

In January 2014, over five years ago, we wrote in our Half Year Report:

> *"As a nervous January in the markets comes to an end, we still believe the ending of active monetary printing is unlikely to derail the economic recovery in the US".*

In July 2015,

> *"[...] the consistency of our view that markets are more than ever driven by the monetary cycle. It has been this protracted low interest rate environment and the endless pushback in expectations as to when it would end that has prompted us to stay so fully invested since the Fund was launched – and if anything, our failing has been in not having a more aggressive risk appetite."*

In January 2016,

> *"Either course starts with the same question: how many hikes will there be in this cycle? The secondary questions are: has the US erred by hiking at all? How can you justify raising rates with so little inflation?"*

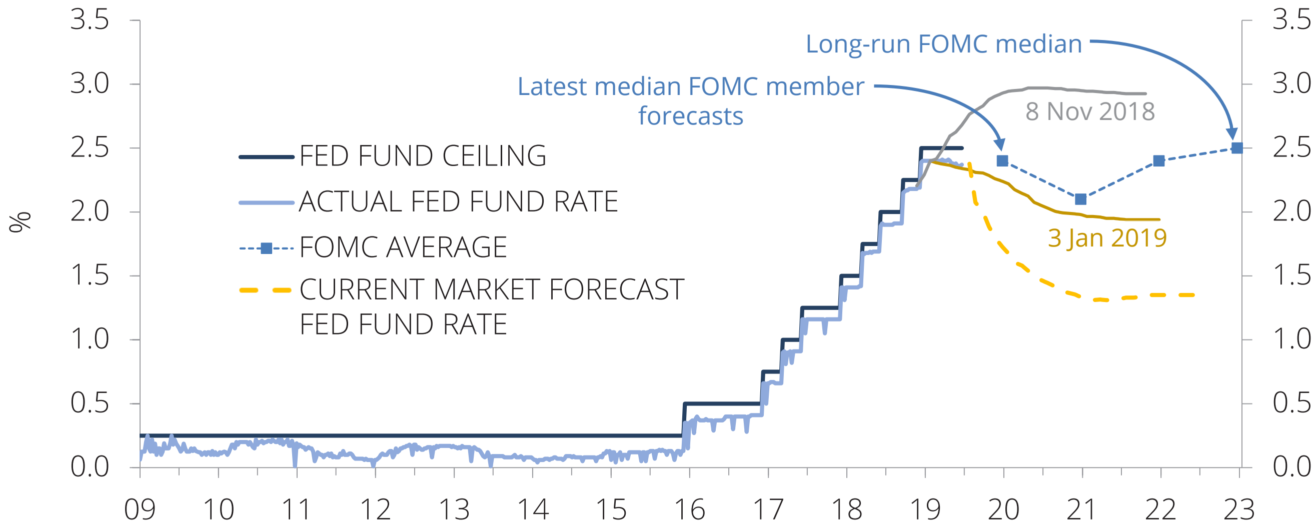
In July 2017, after the Federal Reserve had begun the hiking cycle:

> *"it never looks like higher rates are having an effect, until it is too late. The hard part as an investor is how to position yourself in this phase of the cycle... Selling early and carrying a lot of cash isn't just somewhat costly for investors, it's extremely costly. Markets charge a high fee to claim intellectual bragging rights."*

We repeat the above for a few reasons. Firstly, directionally the firm was right: the cycle will be longer than expected - so stay invested - yet capitalising on this has been incredibly difficult as per the opening quote, with the large drawdowns of 2016 and late 2018.

Secondly, we now have answers to a few of the questions posed over the years. Q: How many hikes in this cycle? A: With the markets implying close to 100% probability of a rate cut in July, nine hikes was what the Quantitative Easing (QE) post-GFC system could bear (**Figure 3**). Substantially more than the bears thought, but also much less than prior cycles.

Figure 3 – Fed Funds target, market and FOMC forecasts



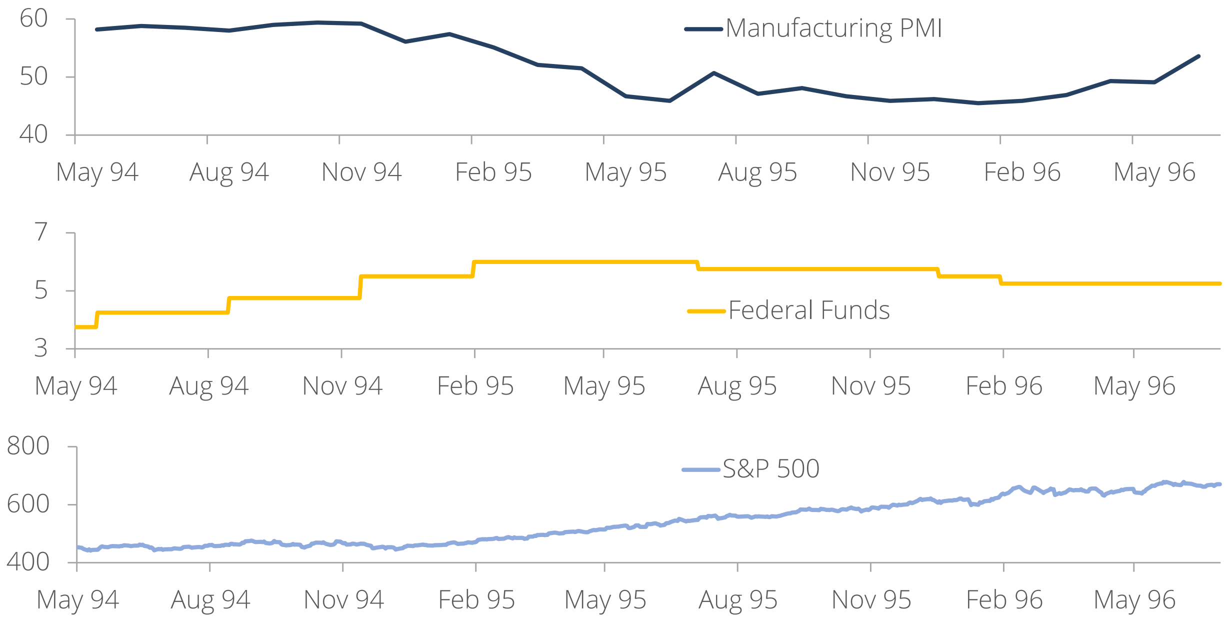
Source: Minack Advisors

As we have noted through the year in our monthly reports, history shows that the Federal Reserve moving from a hiking bias to a pause often sees equity markets look through the weak economic data and rally. This supported our generally positive outlook through the period keeping us fully invested for the majority of the period. However, portfolio hedges applied particularly in May when the tariff issue escalated heavily detracted from performance.

The 1995 analogue in particular is playing out very closely. In 1995, the economic data weakened significantly (top box), which caused the Federal Reserve to move from hiking to a pause, to cutting. Notably, equity markets rally despite this weakness in data (**Figure 4**).

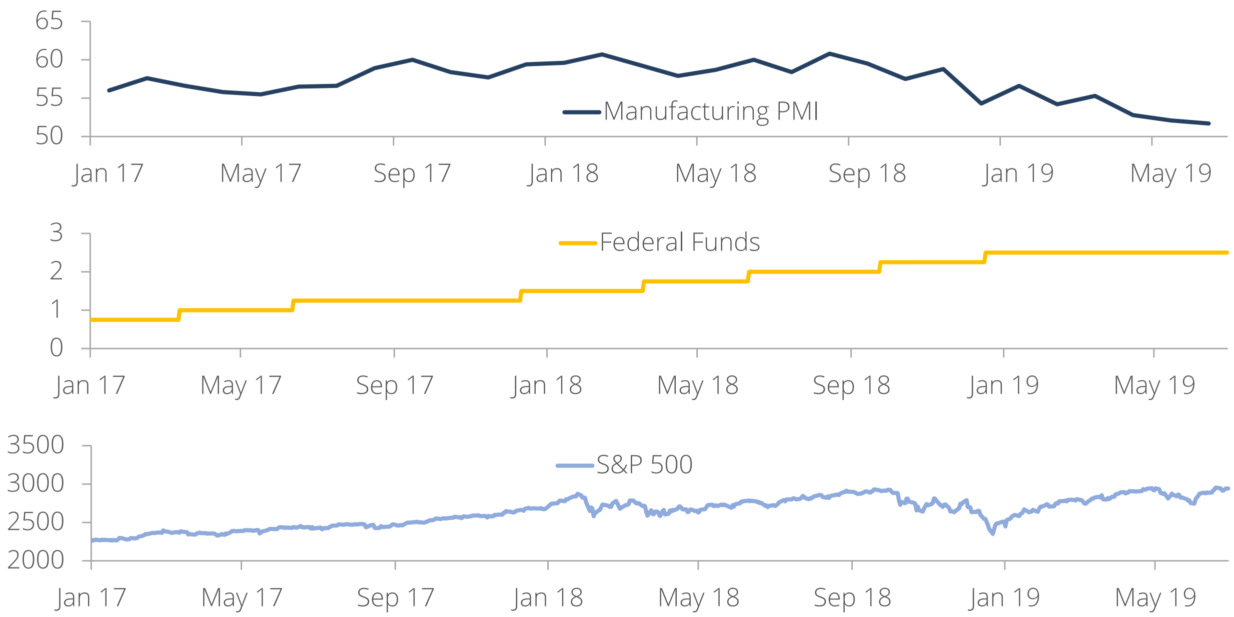
In 2019, the playbook appears to be similar with weakening data about to translate into Fed cutting and equities rallied through all of this (**Figure 5**).

Figure 4 - 1995 ISM Diffusion Index, Fed Funds rate & S&P 500 Index



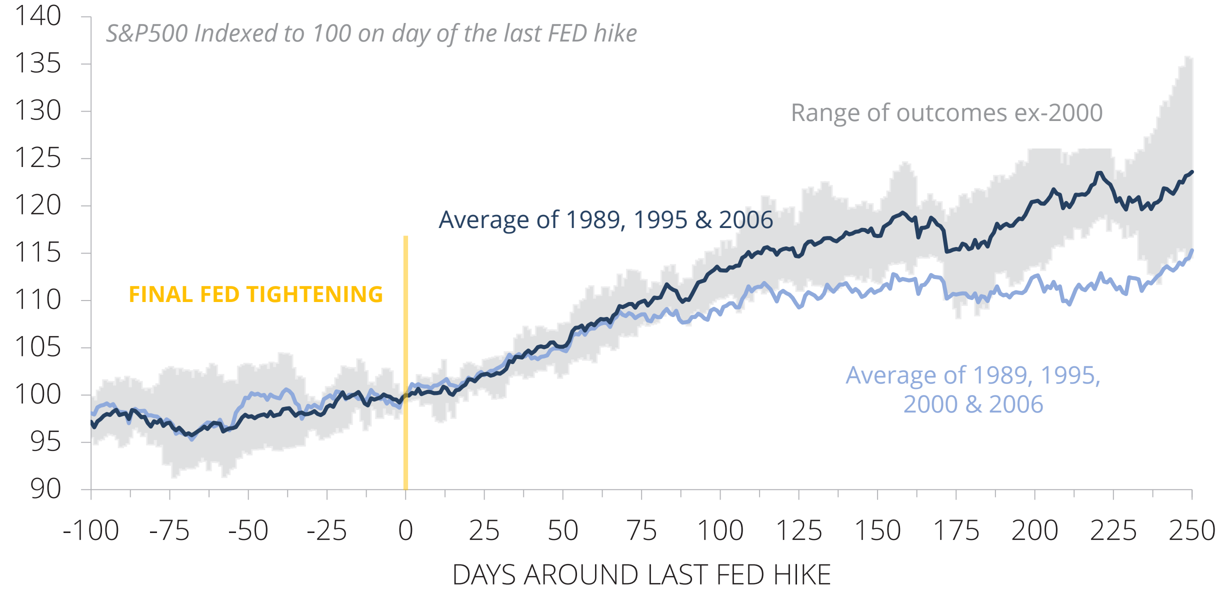
Source: Bloomberg, Team Analysis

Figure 5 - 2019 ISM Diffusion Index, Fed Funds rate & S&P 500 Index



Source: Bloomberg, Team Analysis

Figure 6 – S&P500 around the end of Fed tightening



Source: Minack Advisors

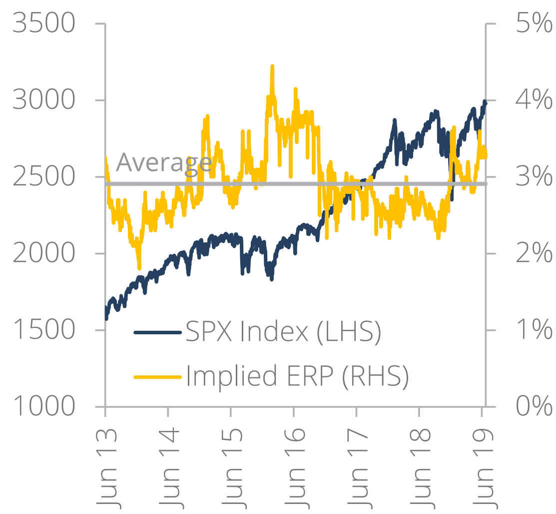
As can be seen above, this is not unusual as equities usually rally under most scenarios, until the data goes heavily against the market, forcing it down (circa 2008 and 2000) (**Figure 6**). In January 2016, we questioned how the Fed would justify raising rates with so little inflation. Now, this has turned into a live question at the Federal Reserve. The persistent inability for inflation to rise above their mandated levels, even with unemployment this low, has clearly worried some at the Federal Reserve. This is why we are looking at the unprecedented actions of cutting interest rates with economic data at levels where cuts have never been done before.

If no recession appears on the horizon, we see lower costs of funding and the return of "TINA" ("There Is No Alternative") sending stocks higher over the coming half. One way to view the upside from TINA is to look at the implied Equity Risk Premia (ERP). This is the premium equity investors get paid for the risk and volatility of equities versus bonds. Despite markets at highs, it is only at the middle of the 5-year range (**Figure 7**).

In summary, we don't see bond yields rising much, but the "mid-cycle slowdown" will see equities trade higher anyway. Later in 2019, if data is still strong, then higher interest rates are likely to cap the move (this will narrow the ERP), or worsening data leads to downgrades (lower EPS can also narrow the ERP).

Any weakening in the US dollar could provide relief for beleaguered Emerging Markets, which have been a side-show to global markets for some time, though we are cautious on this view, having been burnt on this call before! 1998 certainly doesn't provide comfort to the view (hello LTCM and Russian default).

Figure 7 – S&P 500 Index vs Implied ERP

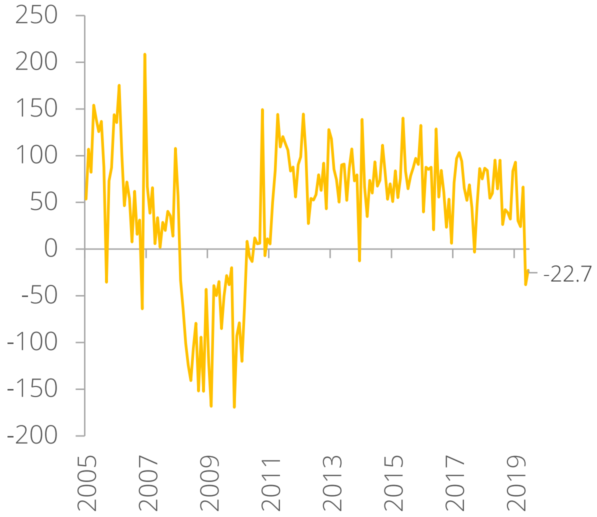


Source: Bloomberg, Team Analysis

So what will we be watching in the second half of 2019? Firstly, that the weakness in regional survey data of manufacturing doesn't affect services, the larger part of the economy.

Secondly, the trends in some underlying metrics of employment data are not great, as we can see in **Figure 8** below.

Figure 8 – ADP small business employment series since 2005



Source: ADP National Employment Report

Now any economic data is going to have some areas of weakness (note the "false alerts" of the rises in job losses in 2012 and 2016), but then we would want to see these areas stabilise.

We would describe our playbook here as: *keep an open mind rather than be dogmatic*. Table pounding isn't a great trait at the best of times as the world is rarely as straightforward as you think, but the range of outcomes here is larger than usual.

We conclude this Outlook by taking a step back from the upcoming half year to peer over the horizon. It appears the world has reached the end of what monetary policy can do. With Europe and Japan interest rates below zero, and even Australia at the verge of QE, the 40-year era of central banks as the maestros of the economy appears to be drawing to a close.

The era of acceptance of neo-liberal market ideas is also closing: two-thirds of Millennials agreed that *"capitalism has failed and governments should exercise more control over the economy"*. This has serious ramifications for economies and markets for the coming decades, as policy is reflective of the moods of the populace.

A phrase we think you will be hearing more of in the not too distant future is *"MMT"* or Modern Monetary Theory. The crux of MMT is the idea that in a fiat currency (like most in the Western world where it is paper backed solely by a governments word), governments cannot default on debt denominated in its own currency and as such, Central Banks can perform "People's QE" where instead of buying just financial assets, they "fund" governments social needs. It is the passing of the baton of controlling the economy and fiscal policy from independent monetary policy run by unelected central bankers back to governments.

If there is one common mood globally, it is a reaction against the inequalities that globalisation and disinflationary monetary policy have wrought on the Western World. The populism of Trump on the right and the hardening of the views on the left are symptomatic of this.

What would be the ramifications of MMT becoming the new standard? Profound and wide-reaching, tearing up every consensus. Which is, by the way, usually what markets do. Secular stagnation – aka Japanification – is no longer the base case. Deflation and lower bond yields are less of a concern, rather higher rates and yields. Infrastructure type assets are poor investments. Equities will probably fare poorly. Assets like gold can once again become a hedge against rampant profligate government. The standing world order is overturned.

Now before you go and sell everything, these are issues for the next downturn and are not necessarily what economies and populaces will choose. But we feel it's important to think ahead of emerging issues, rather than simply reacting naively when we get there. It is an area we will be watching closely.

HOSTAGES TO FORTUNE: ANTI-PREDICTIONS FOR THE SECOND HALF OF 2019

"A good forecaster is not smarter than everyone else, he merely has his ignorance better organised."

Anonymous

As usual, we finish our report with a series of "non-predictions" for things we do not think will happen between now and December 31st, 2019. First, we must reflect on the performance of our last set of "anti-forecasts" over the half that just ended.

BACK CHECK

Emerging Markets will NOT underperform Developed Markets

Miss! Our optimism on Emerging Markets based on their better performance through the December sell-off proved to be misplaced. US dollar strength, further trade wars, and weaker economic data meant they lagged behind Developed Markets - mainly the US - again.

Short-Term Interest (2-year yields) rates will NOT be lower

Miss! The first line of the prediction started so well "a Federal Reserve that walks back on their rate hikes" - which was indeed the case. The rest was completely wrong. Rates markets are now pricing four rate cuts in the next 12 months, pulling the 2-year yields down dramatically over the half.

The US market will NOT finish below the December 2018 lows

Hit! A win and a comprehensive victory at that with nearly every part of this prediction on slower growth and a Fed backing off being correct. Equity markets did indeed climb this wall of worry, climbing even higher than we initially dared to believe.

Europe will NOT outperform Japan

Miss! With Europe largely tracking other global markets, it was the Japan part that was the disappointment here, with Europe up 15.8% (USD) and Japan only up 6.5% (USD) for the half. Japanese earnings have been caught in the downdraft of global growth concerns, with valuation providing no support.

Australia will NOT avoid political volatility, meaning another half of underperformance

Draw! When put in constant currency (so both in USD or AUD) the difference is less than 1%, but would be zero if dividends are added back. The meat of the call – a Labor party victory with higher taxes – was substantially wrong though. This and the Reserve Bank of Australia interest rate cuts driving money into yielding equities more than offset the weaker housing market and lower Australian dollar.

So, 1.5/5 – down there with some of our poor prognosticating halves, but the inverse of last year with the most important call – that equities rise – offsetting the hit rate.

NEW VIEWS

We conclude this report looking at our predictions of what WILL NOT happen by December 31st, 2019.

The Federal Reserve will NOT cut interest rates three times (or 75bps) in 2019

Is the bond market the boss of the Federal Reserve? Or Donald Trump? Because either way, the divorce between the data and rate markets is huge. Consider this – the market is pricing more cuts than at the start of the GFC. Maybe we have one, but data will have to rapidly fall apart for that to happen.

Indian long-term bond rates will NOT end above 7%

Trend Inflation in India appears to have halved, to below 4%. At the same time, bond rates have only fallen to about 7%, which mean real interest rates in India are now some of the highest in the world. With economic growth declining – possibly to below 6%, the Reserve Bank of India has finally started to cut policy rates, but will probably have to cut much more than the market expects. Since the yield curve in India has historically always been quite flat, we believe these cuts will drag bond rates down with them, possibly to as low as 5.5% over the next twelve months.

Reported Chinese Growth will NOT fall below 6%

The Chinese are preparing for the "Long March" and will stand by their economy to help weather the storm. Should global trade continue to suffer, the Chinese will use their many tools to support both the economy and the stock market.

Brexit will NOT matter

Brexit headlines have made a resurgence in 2019 as the 3-year exit deadline came and ultimately got kicked down the road. Even in the event of a hard Brexit, global markets will be able to digest it (defined by less than 2% fall on the day of hard Brexit should it occur).

The Australian dollar will NOT finish below the current low of 2019 (67.4c)

It was the year a US President resigned in disgrace, rather than face impeachment. We are talking 1974, Watergate and Nixon. It was also the last time Australia ran a Current Account Surplus (CAS). With iron ore at record highs and a slowing domestic economy meaning lower demand for imports, Australia may just record its first CAS since 1974 later this half. It's hard for CAS countries to have sharply weaker currencies, so with everyone short the AUD and despite domestic problems, the backdrop suggests downside is more limited for now. Let's see if history repeats on the US President resigning.

GLOSSARY

Alpha
Alpha, sometimes called the 'active return' on an investment, gauges the performance of an investment against a market index or benchmark which is considered to represent the market's movement as a whole.

Bond
A bond is a fixed income investment in which an investor loans money to an entity (typically corporate or governmental) which borrows the funds for a defined period of time at a variable or fixed interest rate. Bonds are one of the three main generic asset classes, along with stocks (equities) and cash equivalents. The indebted entity (issuer) issues a bond that contractually states the interest rate that will be paid and the time at which the loaned funds (bond principal) must be returned (maturity date).

Consumer Price Index (CPI) and Core CPI
The Consumer Price Index (CPI) is a broad measure of inflation within an economy in relation to the cost of goods and services. That figure can have a significant impact on the value of a currency in relation to the currencies of other nations. The Core CPI excludes costs in the energy and food sectors, which tend to experience greater price volatility over time.

Credit Spread
A credit spread is the difference in yield between a Treasury bond and a debt security with the same maturity. To illustrate, if a 10-year Treasury bond has a yield of 2.54% while a 10-year corporate bond has a yield of 4.60%, then the corporate bond offers a spread of 206 basis points over the Treasury bond.

Dividend Yield
A financial ratio that indicates how much a company pays out in dividends each year relative to its share price. Dividend yield is represented as a percentage and can be calculated as follow:
Dividend Yield = (Annual Dividend Per Share) / (Price Per Share).

Federal Funds Rate
The Federal funds rate is the rate at which depository institutions (banks) lend reserve balances to other banks on an overnight basis and is set by the Federal Reserve. The Federal Funds rate is one of the most important interest rates in the U.S. economy since it affects monetary and financial conditions, which in turn have a bearing on critical aspects of the broad economy including employment, growth, and inflation.

Gross Domestic Product (GDP) and Real GDP
The market value of all goods and services produced within the economy in a given period of time.
Real GDP is an inflation-adjusted measure that reflects the value of all goods and services produced by an economy in a given year.

Source: CFA Institute and Investopedia

NTA
Net tangible assets are meant to represent a company's total amount of physical assets minus any liabilities within the company.

Pairs trade
A basic long–short trade in which an investor is long and short equal currency amounts of two common stocks in a single industry.

Price to Earnings Ratio (P/E)
The ratio of a company's current share price to its per-share earnings. the price-earnings ratio indicates the dollar amount an investor can expect to invest in a company in order to receive one dollar of that company's earnings. A high P/E ratio suggests that the company's share price is expensive relative to the company's profits, which usually implies that investors are expecting the company's future profits to grow quickly.

Purchasing Manager Index (PMI)
The Purchasing Managers' Index is an indicator of the economic health of the manufacturing sector. The PMI is based on five major indicators: new orders, inventory levels, production, supplier deliveries and the employment environment.

Real interest rate
A real interest rate is an interest rate that has been adjusted to remove the effects of inflation. The real interest rate is calculated as follow:
Real Interest Rate = Nominal Interest Rate - Inflation (Expected or Actual).

Sharpe Ratio
The Sharpe ratio is the average return earned in excess of the risk-free rate per unit of volatility or total risk. The Sharpe ratio has become the most widely used method for calculating risk-adjusted return. The ratio describes how much excess return you are receiving for the extra volatility that you endure for holding a riskier asset.

Short Selling or Shorting
A transaction utilised to generate a profit from the fall in price of a financial security such as shares, indices, commodities or other financial assets. Short selling is the sale of a security that is not owned by the seller or that the seller has borrowed. It may be prompted by the desire to hedge the downside risk of a long position in the same security or a related one.

US 10-year treasury yields
It refers to the return on an investment in a US government 10-year debt obligation. The 10-year U.S. Treasury bond can help gauge investor sentiment. High investor confidence means falling prices and demand for the 10-year Treasury, and therefore a higher yield, because investors are confident they can find other investments with better returns. Prices rise and its yield decreases when confidence is low as there's more demand for this safe investment.

Global Responsible Investors

Morphic Asset Management Pty Ltd
Level 11, 179 Elizabeth Street, Sydney NSW 2000 Australia
ABN 33 155 937 901 | AFSL 419916
+61 2 9021 7726
www.morphicasset.com