Morphic
Asset
Management

HALF YEAR REPORT

January - June

2018

Global Responsible Investors

Morphic
Asset Management

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MORPHIC ASSET MANAGEMENT TEAM

*Jack Lowenstein, Chad Slater, Geoff Wood, James Tayler,
Irene Kardasis, Nadeem Ali, Cameron Halkett, Claudia Kwan, Daniel Hayman,
Lucina Martin, Eva Trabaud*

Jack Lowenstein

Managing Director

Dear Investor,

The first half of 2018 saw us once again deliver gains for investors in the Morphic Global Opportunities Fund (MGOF) and the Morphic Ethical Equities Fund (ASX: MEC) of 3.7% and 3.4% respectively.

Investors have again been better off investing in offshore assets through us than in the local market, where the Australian All Ordinaries Index was up just 2.3% over the half. This was against a backdrop of rallying oil stocks. Over time, we expect our ethical screens to add value and reduce risk.

In March this year, we launched the first ethically screened global equities fund using a long/short process with an intense focus on risk management offered to European investors in the UCITS format – equivalent to an Australian public unit trust. My Morphic co-founder Chad Slater is spearheading the Trium Morphic ESG L/S Fund and is rapidly becoming a leader in integrating environmental, social and governance (ESG) factors as performance enhancing tools.

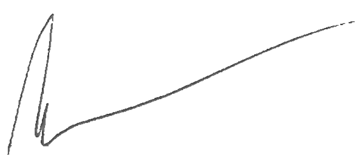
Our governance focus saw us intensify engagement with Japanese construction company Haseko. Haseko runs a good business. Its management is honest and competent. Following private discussions with the company that were partially successful, it was decided it was in the best interest of shareholders to disclose these proposals to the wider public, resulting in wide coverage including the Australian Financial Review. Investors can see the original letter to the company on our website.

Going public means we risk limiting our future access to Japanese companies – but we feel that responsible investors must sometimes speak up in the name of better governance. We hope other larger activist shareholders on Haseko's share register will now maintain pressure behind the scenes.

Finally, we were pleased to declare an inaugural dividend to MEC shareholders in May. Good returns in the first nine months as a listed company allowed us to bring this forward six months and be reasonably confident we could maintain semi-annual dividends for at least two years.

During July, our Head of Marketing Irene Kardasis and I will once again crisscross Australia, meeting investors. You can register to join our meeting in your home town here. We look forward to interacting with many of our extremely smart investors. If you can't make it, please feel free to contact us with any questions.

Kind Regards,



Jack Lowenstein

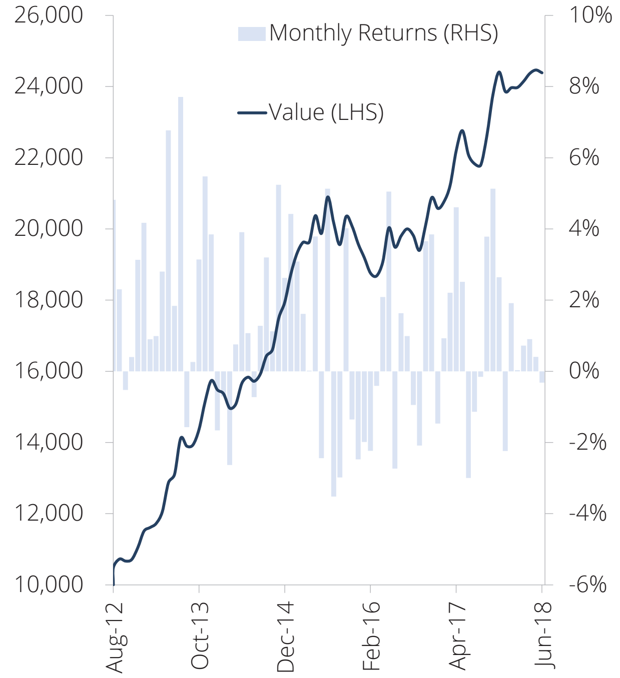
MORPHIC GLOBAL OPPORTUNITIES FUND

CERTIFIED BY RIAA

INVESTMENT RETURNS[1]

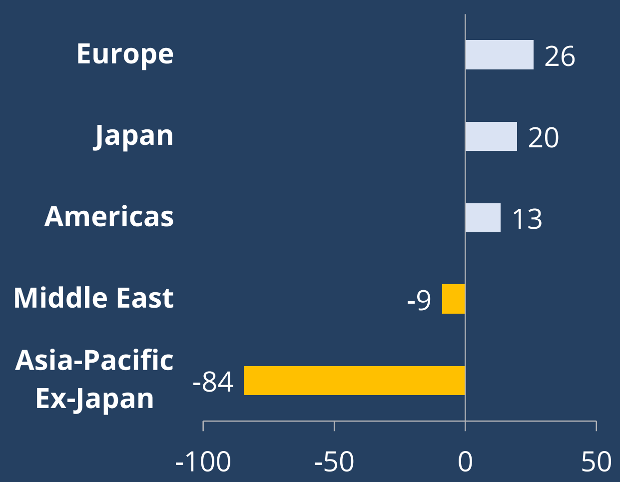
	MGOF	Index[2]
6 Months	3.7%	5.4%
1 Year	12.1%	15.0%
3 Years p.a.	7.6%	9.6%
5 Years p.a.	13.6%	14.2%
ITD p.a.	16.6%	17.3%

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]

- **Bank of Internet** 48 bps
- ***Panalpina*** *41 bps*
- **Alstom** 36 bps

TOP ALPHA DETRACTORS OVER THE LAST SIX MONTHS[3]

- **China Everbright** -39 bps
- ***Prada*** *-36 bps*
- **Philips Lighting** -32 bps

1 As at June 2018; 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.

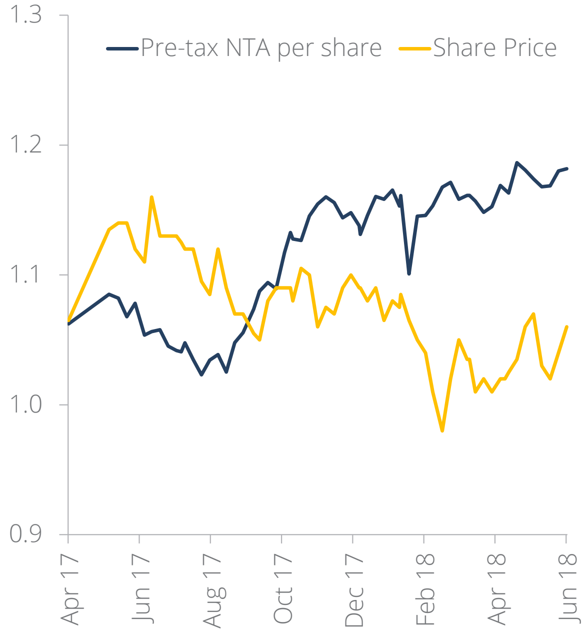
MORPHIC ETHICAL EQUITIES FUND

CERTIFIED BY RIAA

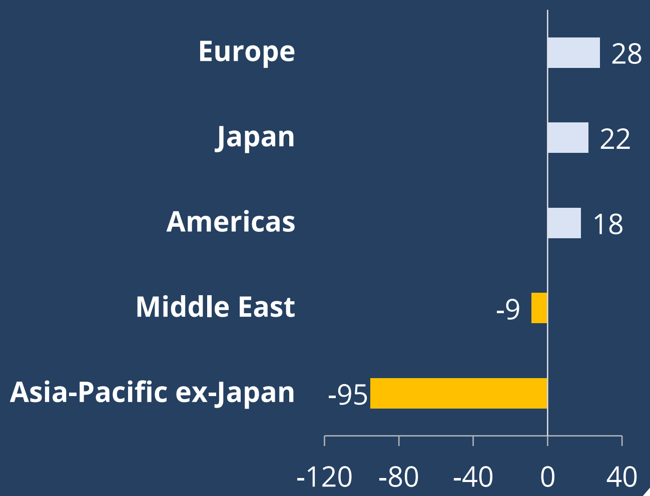
INVESTMENT RETURNS[1]

	MEC	Index[2]
6 Months	3.4%	5.4%
1 year	11.5%	15.0%
ITD p.a.	9.2%	12.9%

MEC SHARE PRICE VS NTA[3]



6-MONTH EQUITY ALPHA BY REGION



TOP THREE CONTRIBUTORS OVER THE LAST SIX MONTHS[4]

- **Bank of Internet** 50 bps
- ***Panalpina*** *41 bps*
- **Alstom** 36 bps

TOP THREE DETRACTORS OVER THE LAST SIX MONTHS[4]

- **China Everbright** -37 bps
- ***Prada*** *-35 bps*
- **Philips Lighting** -31 bps

1 As at June 2018; 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 2018; 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

> *Yesterday all my troubles seemed so far away.*
> *Now it looks as though they're here to stay.*

"Yesterday", the Beatles, 1965

One of the joys (?) of investing is that whilst there are some constants, market dynamics continually change. At the start of 2018, our half yearly report reflected on the "salad days" of 2017, highlighting the high risk adjusted returns (or what is technically referred to as a Sharpe Ratio) from US equities and the lowest drawdown on record for Emerging Markets equities. To many investors, the "yesterday" of a few short months ago already seems like the distant past as dispersion between different markets and volatility reasserted themselves in 2018.

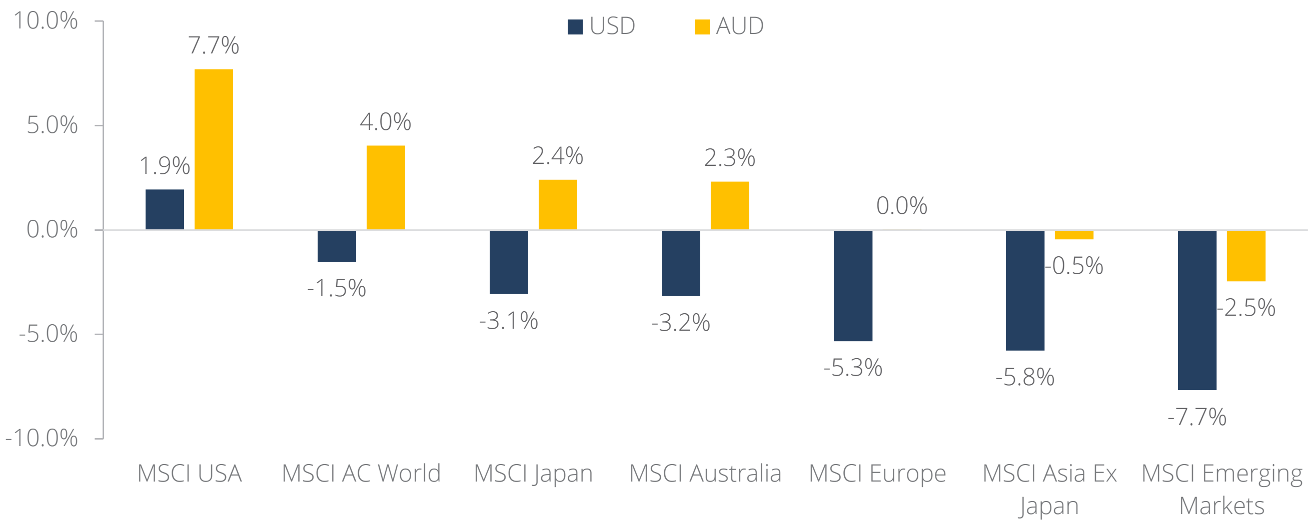
The first half of 2018 started with a bang, but ultimately provided very little for anyone. A ripping rally in January of over 7% in global markets, was followed by the implosion of volatility funds and a 9% fall. Yet for the bears, we sit here with two of the world's largest markets (Nasdaq and Russell 2000) trading near all-time highs. Anyone who chose to short those has nothing but losses to show. On the other hand, those long Emerging Markets have had a torrid time, being down now 19% since the January highs.

Put together, this saw global markets fall just over 1% in USD terms over the half, masking the divergent currents under the surface. **Figure 1** shows the dispersion of returns over the half by region.

What was the cause of this? We would say primarily politics, but that would do a disservice to the monetary forces shaping in the background.

Ruminating on the machinations of President Trump can be entertaining if disquieting for those of us with memories back to the Nixon era, but there is little we can add on this front. What we would say is that in many respects no one should be surprised. He ran an anti-immigration and anti-trade platform.

Figure 1 – Equity markets returns in USD and AUD (H1 2018)



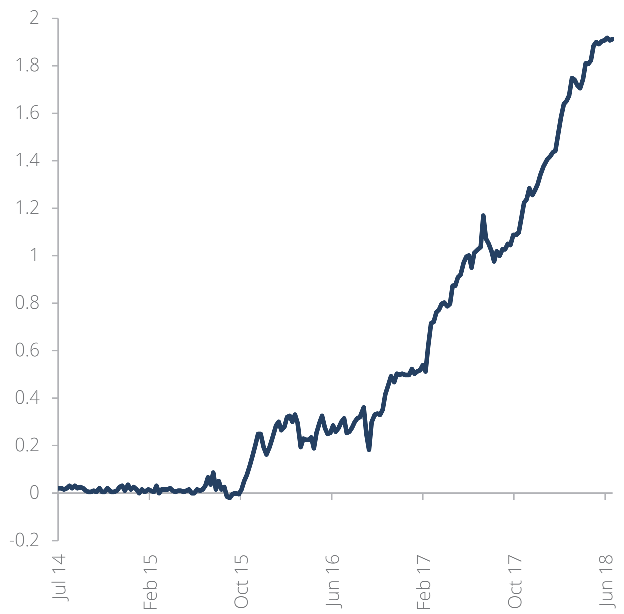
Source: Bloomberg, Team Analysis

His main trade policy advisor, Peter Navarro, wrote a book titled "Death by China: Confronting the Dragon – A Global Call to Action" in 2011. And yet in 2018, markets have reacted negatively, having not done so through 2017 and late 2016.

This suggests a more likely catalyst: rapidly tightening monetary conditions through 2018. Looking at **Figure 2**, US money market rates have now been rising since late 2015. It took a decade for them to move from 0% to 0.5%; now in the space of 18 months they have gone from 0.5% to nearly 2% and for the first time, the Federal Reserve looks like it will deliver on its forecasts (more on that later in our Outlook section). On top of this, whilst we aren't subscribers to some of the more outlandish claims of the effects of the post-GFC money printing in the US, its partial reversal as the reduction of the Federal Reserve balance sheet gets underway will at the very least not add to liquidity.

What normally happens at this point in a cycle is corporate earnings accelerate (they have) and share market earnings multiples fall.

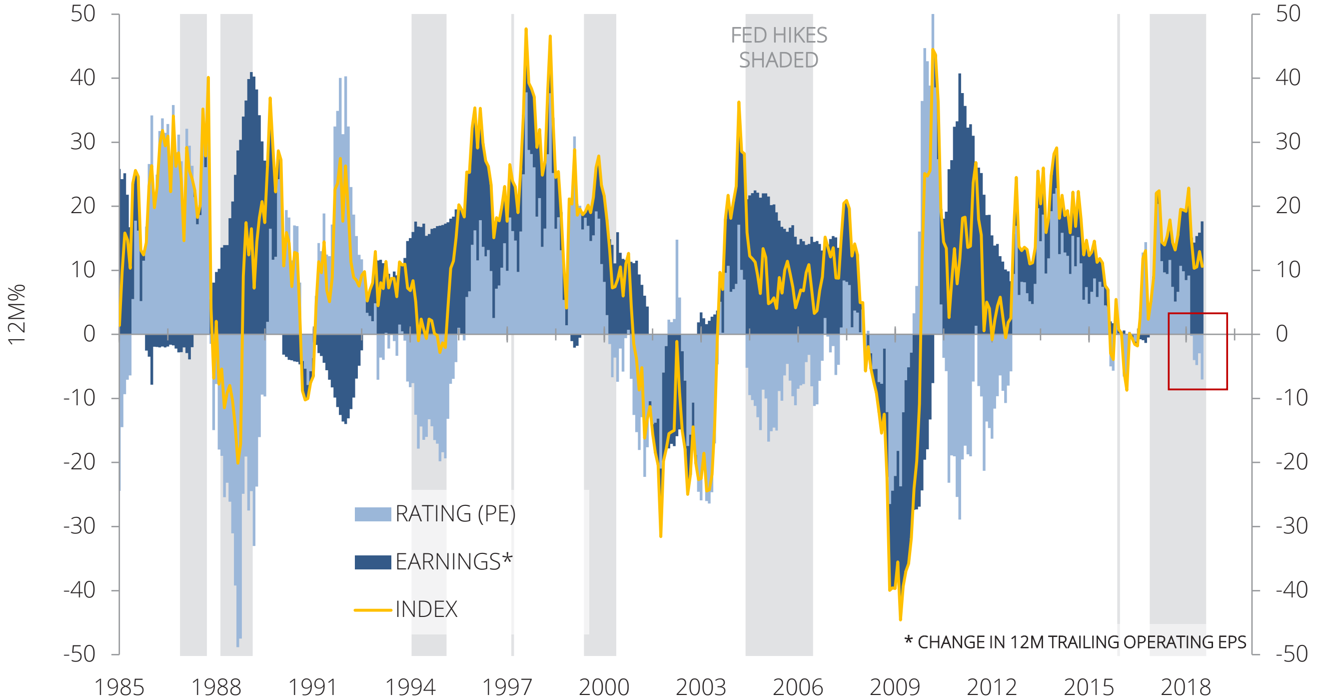
Figure 2 – Yield on 6-Month US Bonds



Source: Bloomberg, Team Analysis

As we wrote extensively last half, 2017 was an anomaly in that falling long end interest rates caused higher P/E's. Hindsight would suggest the market this year was due for a "give back" what it "took" last year (**Figure 3**).

Figure 3 – US stock market returns split into change in P/E & earnings



Source: Minack Advisors

This half we were correct in predicting that this year would look like 2005: tightening by the Federal Reserve and a flattening curve. Where we were wrong was on what this would mean for equity markets.

In 2005, this was a prescription for cyclicals and non-US stocks to do well as the global expansion saw the laggard markets catch-up.

Instead, the first half of 2018 turned out more like 1998/99: a narrowing of US stocks' leadership, led by the Tech sector, with all other markets lagging (**Figure 1**). Growth outside of the US has faltered rather than accelerated. Combined with the Federal Reserve pushing harder on rates and US tax cuts, the US dollar has risen, again more in line with 1998/99. This is an unhealthy combination for non-US assets, be it EM bonds or EM Equities.

Against this backdrop, the Morphic Global Opportunities Fund and the Morphic Ethical Equities Fund underperformed over the half, delivering 3.7% and 3.4% return respectively, compared to global markets up 5.4%. The primary driver of underperformance came from the Funds' overweight to Asia, with the largest detractor being Asia-Ex Japan, the reasons for this underperformance being discussed earlier.

Turning to implementation, Long/Short pairs added to performance, short positions were a small positive and the long stocks selection was a detractor. Net exposure management was a detractor.

Our best decision in the half was increasing the size of our market-neutral pair in the global freight forwarding industry where we were long Denmark's **DSV A/S (DSV DC)** and short **Panalpina (PWTN SW)** in Switzerland. One of the strengths of using a Long/Short investment process is to eliminate market risk whilst allowing a total focus on differences in management quality and/or relative pricing between two stocks. Growth in this industry relies on two things: a good contact list and more demand for container shipping. PWTN is seeing a decrease in global trade flows and the removal of the "middle man". Further exacerbating matters, PWTN's implementation of a new SAP management software system is not going well. We closed the position after the market responded savagely to PWTN reporting even worse than expected earnings. We will be watching it for a point to re-enter.

Hong Kong listed Chinese waste-to-energy company **China Everbright International (CEI) (257 HK)** was a drag on performance. Over the half, we blogged about the company, having spent a day on site in China. From an operational perspective, the business remains on track. The company is winning projects and funding for competitors is tightening. The sin behind CEI's disappointing performance is probably just that it is Chinese. The purpose of risk rules and stop losses is to allow the Funds to take time out to reflect whether an original thesis is still intact. As of time of writing, it would seem so in this case.

One of the new additions for the half, **China Water Affairs Group (CWAG) (855 HK)** did rather better than CEI. Like CEI, this was selected as an under-valued stock that would benefit from China's increased focus on environment protection. The stock is one fifth owned by Orix, Japan's largest leasing company, and Orix's President sits on CWAG's Board of Directors. The company ticks both sustainability characteristics of "Environment" and "Governance", and its low valuation (a P/E of 10x) is compelling.

CHINA WATER AFFAIRS

1.2

BILLION M³

VOLUME OF NATURAL PURIFIED WATER AND SEWAGE TREATMENT

IN 2017

GreenTree Inn®

80%

LANDFILL WASTE REDUCTION THANKS TO PUMP DISPENSERS

LIGHTING ENERGY COSTS REDUCTION

97%

IN 2017

WE INVEST IN COMPANIES THAT MAKE A DIFFERENCE

... AND WE PUSH FOR BETTER GOVERNANCE STANDARDS

HASEKO

2018

1ST

APPOINTED TO BOD SINCE 1946

38%

NON EXECUTIVE DIRECTORS ON BOARD

RISK MANAGEMENT

> *If you want to see the sunshine, you have to weather the storm.*
>
> **Frank Lane**

As is often the case with pick-ups in volatility, large market swings tend to cluster. So it proved in the first half of 2018. While in 2017, we never saw a period when the US S&P 500 was down more than 5%, 2018 has so far been the polar opposite. The US stock market this half has travelled over 40%, adding in all the weekly swings, to end up pretty much where it started. In February, the US market fell more than 11% in less than 2 weeks, unwinding all its rally of the prior 3 months.

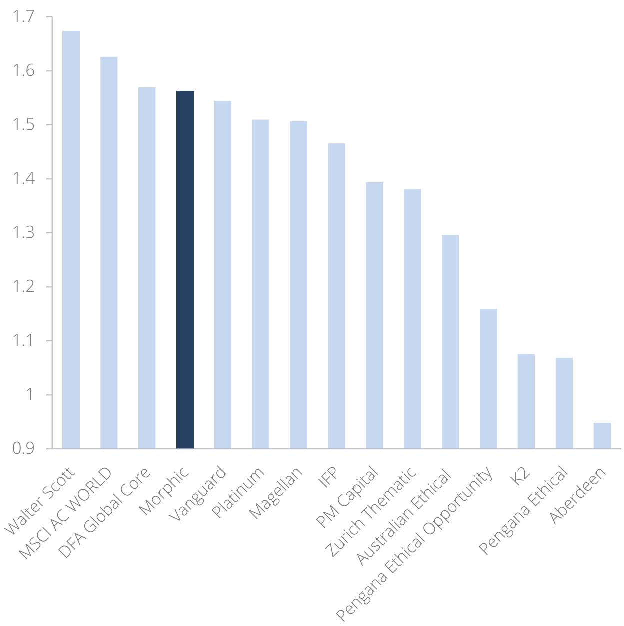
As we have argued previously, the unintended consequences of increased regulation and technological changes in the way markets operate mean the financial system may be becoming more, not less fragile. This came to the fore during this period. Widespread selling from various computer-driven strategies and a lack of market players to absorb this flow resulted in sharp down moves. Our understanding of the situation allowed us to stay calm and fully invested, avoiding the panic selling that gripped many. The market has since bounced back towards its highs. During this period, the moves were significant enough that we put out a note to Investors to keep them informed of our thinking.

A pivotal moment in the half was in early March when Trump's highly regarded Economic advisor Gary Cohn resigned in protest over Trump's views on tariffs. We interpreted this as a sign of serious things to come and cash was raised to close to 20%. However, the market preferred to concentrate on the earnings outlook and rallied another 4%, and we reduced cash accordingly. Holding cash is a drag on performance when the market rallies. However, our assessment ultimately proved correct and markets have now refocussed on tariffs. With the US stock market close to highs, we again raised cash towards the end of the half.

While markets have become extremely efficient at pricing economic developments, they are still wearing their training wheels when it comes to politics. The last few years have seen a continual under-pricing of political risks with too low a probability being assigned to the chances of either political or policy change actually occurring. Financial markets are living and learning mechanisms and will adapt to this new world.

2018 is likely to continue to be a volatile period and we will stay vigilant and agile to market developments.

Figure 4 – Morphic's Sharpe Ratio vs relevant peers* (August 2012 to June 2018)



Source: Peers' websites, Team Analysis

** Walter Scott Global Equity Fund, MSCI AC World Index, DFA Dimensional Global Core Equity Trust, Morphic Global Opportunities Fund, Vanguard Index International Shares Fund, Platinum International Fund, Magellan Global Fund, IFP Global Franchise Fund, PM Capital Global Companies Fund, Zurich Investment Unhedged Global Thematic Share Fund, Australian Ethical International Share Fund, Pengana International - Ethical Opportunity, K2 Select International Fund, Pengana International - Ethical, Aberdeen International Equity Fund. Our Sharpe Ratio calculation methodology changed from using the USD as the risk-free rate to the Australian RBA Cash rate.*

SPECIAL FOCUS: THOUGHTS FROM THE ROAD IN CHINA

“摸着石头过河

Cross the river by feeling the stones.”

Deng Xiaoping

SF express, JD.com and Kuaidi together with YTO

Source: Team travel photos

My first visit to mainland China was in 1999 and thereafter the majority of my time living in China was spent in Kunming, in the SW province of Yunnan. Since first visiting Beijing, change has been profound, although the slowdown in Gross Domestic Product (GDP) growth has been less dramatic since 2010.

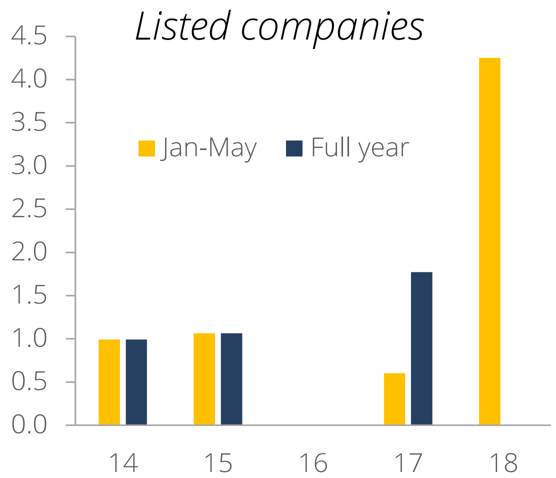
Returning to Beijing last month for the annual Morgan Stanley China Conference reminded me that China can be confusing is so many ways for visitors. It is poor, but rich; backwards, but advanced; open, yet controlled. In some ways, life is less restrictive than Australia as I found when I jumped into a taxi with two toddlers: no baby seats and no questions! In other ways, it is more restrictive: without a local bank account, there is little access to the smartphone “apps” that have quickly become a necessity to live in China.

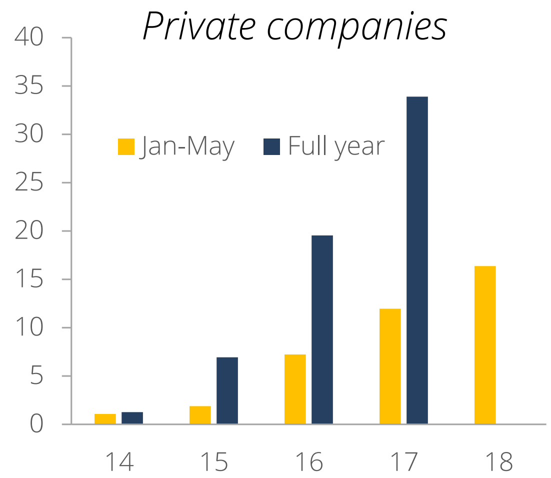
This proliferation of “everything digital” was one noticeable trend in both the companies presenting at the conference and the people’s habits in China.

In the early 2000s, online travel booking service Ctrip was just starting to take market shares from the mom and pop shops selling train and airline tickets from store fronts. During the last 15 years or so, Ctrip has attracted severe competition as the idea of booking travel offline is now seen as archaic. Actually, doing anything offline seems largely archaic. Boston Consulting Group (BCG) estimates that 90% of consumer journeys have at least one digital touch point already. A clear sign was the number of dianpingche (electric vehicles) with courier boxes on the back zipping around the city. However, according to a recent study by the BCG and the Alibaba Research Institute, the middle class are moving back offline and you are now seeing the emergence of the much talked about 020 (online 2 offline) consumption. The pure example of this is Alibaba’s Hema supermarkets.

Growth for the sake of growth is over and, in its place, has come a concept of quality growth. We have seen a clampdown on corruption, and a focus on eliminating “zombie” companies as well as a growing intolerance for poor quality companies as noted by the increasing number of bond defaults (**Figure 5** and **6** next page).

Figure 5 & 6 – Bond defaults by Listed and Private Companies (in RMB bn) between January 2014 and May 2018





Source: Wind, Macquarie Macro Strategy

GDP growth is forecast to fall to 6.5% as the external demand tailwind tapers off and we expect even slower domestic growth as a result of deleveraging and slowing credit growth. Typically under this scenario, assuming no disorderly unwind, the market provides a good source of alpha generation.

DISPERSION AND STOCKS

Consolidation in the resource sector has resulted in many small companies disappearing and a more balanced supply/demand dynamic; high risk funding in the construction sector under the umbrella of "public private partnerships" has now been restricted; auto makers with superior value propositions for consumers are outperforming their peers. Evidence that dispersion is already starting to take place.

As an ESG fund, we are also seeing the improving trends associated with environmental practices and disclosure; addressing social imbalances and more sound governance practices. The inclusion of China large-cap A shares to the MSCI Emerging Markets Index reinforces this trend and the breadth of opportunity for ESG-minded investors.

TRADE TENSIONS AND MACRO RISKS

Tensions with the US have yet to have an impact on the real economy. The trade relationship is complex with inter-dependence throughout the product lifecycle and supply networks. A Peterson Institute for International Economics (PIIE) study highlights that on average, 60% of China's exports to the US are from non-Chinese multi-national corporations. As such, the impact is unlikely to be confined to the US and China only.

Premier Li Keqiang's "Made in China 2025" plan focussed on high-tech fields, appears to be coming in direct competition with the technological leadership currently held by the US. The longer the trade tensions continue, the higher the risk that the real economy will be impacted, implying downside risk to expected GDP forecasts.

In the longer-term however, the next generation will not associate "Made in China" with cheap junk but high-tech products that (hopefully) contribute to an improvement in quality of life. Under this scenario, we expect divergence within sectors and look to handpick selected stocks with strong profitability profiles.

I remain optimistic on both the outlook for China and the ways to make money from stocks in China. In 1999 when I moved to live in China, GDP per capita was $873. Today it is $8,123. One quirk of economic growth is that as it slows, this is often associated with better returns for equity investors. The slowing of GDP growth along with the increased focus on "quality growth" should also increase the ways we can apply our ESG lens to stocks in China. We are already seeing that in a number of companies we meet with and own.

Claudia Kwan

Investment Analyst, Morphic Asset Management

OUTLOOK

"Far more money has been lost by investors preparing for corrections or trying to anticipate corrections than has been lost in corrections themselves."

Peter Lynch

Whilst economic data in the last half was broadly expansionary, clearly equity returns were not as great. For this Outlook section, let's take a step back and firstly talk about the most common phrase heard amongst the bears: "the flattening yield curve means recession is near". Heck, they've even got [the Federal Reserve weighing in](#).

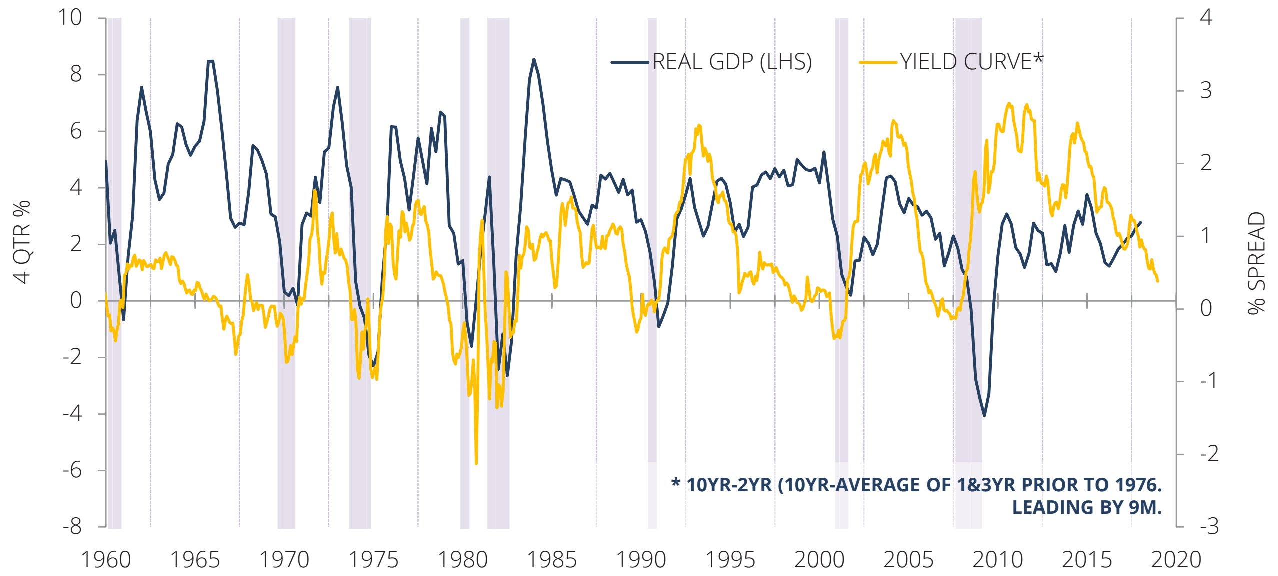
So, what exactly is a flattening yield curve? The most common description refers to spread or gap between what an investor receives on a 2-year government bond and a 10-year government bond. When the interest rate on 2-year bonds is above the 10-year bonds rate, the curve is said to be "inverted" and this has often – though not always – been a predictor of a recession (**Figure 7**). The saying in markets is that *"bonds lead you into recession and equities lead you out"*.

MORE TO THE CURVE THAN MEETS THE EYE

With the spread at a lowly 0.4%, the lowest since 2009, one can see reasons for the fear of a recession. Yet, as is often the case, things in life aren't so simple.

The curve can stay flat for an extended period. In early 1998, the curve went to a gap of 0%... and then stayed in a range of 0-0.5% until early 2000. In 2005, it hit zero and traded near there until the end of 2006.

Figure 7 – Yield Curve and GDP growth since 1960



Source: Minack Advisors

In each case, no immediate recession eventuated and equity markets did well as **Figure 8** shows.

On average, stocks return above their long-term average at this point in the cycle. How about after the curve inverts? Still pretty good, although the 2-year returns are much less compelling, suggesting that once the curve has inverted investors are on "borrowed time".

THREE MAJOR RISKS TO A BULLISH POSITIONING

A reader could however point out that Morphic has been bullish this year and thus far wrong. To prevent what behavioural economists call "anchoring" and harsher critics might describe as "intellectual stubbornness", we spend a lot of time thinking of counterfactual arguments and there are three areas we would identify as a risk to this thesis.

1. **"The yield curve signal doesn't work".** The basis of this argument is that with the Quantitative Easing (QE) and bond buying in this cycle, the curve isn't as good a predictor as it once was.

   We have two issues with this argument: firstly, the curve has proven to work through this cycle. It was dismissed in 2016, 2014 and 2012 by some of these bears when QE was ending. Their form on this is not great.

2. **"Politics now matter".** One of the defining characteristics of the last 40 years has been the convergence of opinions amongst the political class that there was an agreed way forward: openness; globalisation; capitalism. As such, investors in Developed Markets could largely ignore which party was in power, unlike in Emerging Markets. Arguably, the rise of Trump has overturned this and Developed Markets will now trade more like Emerging Markets.

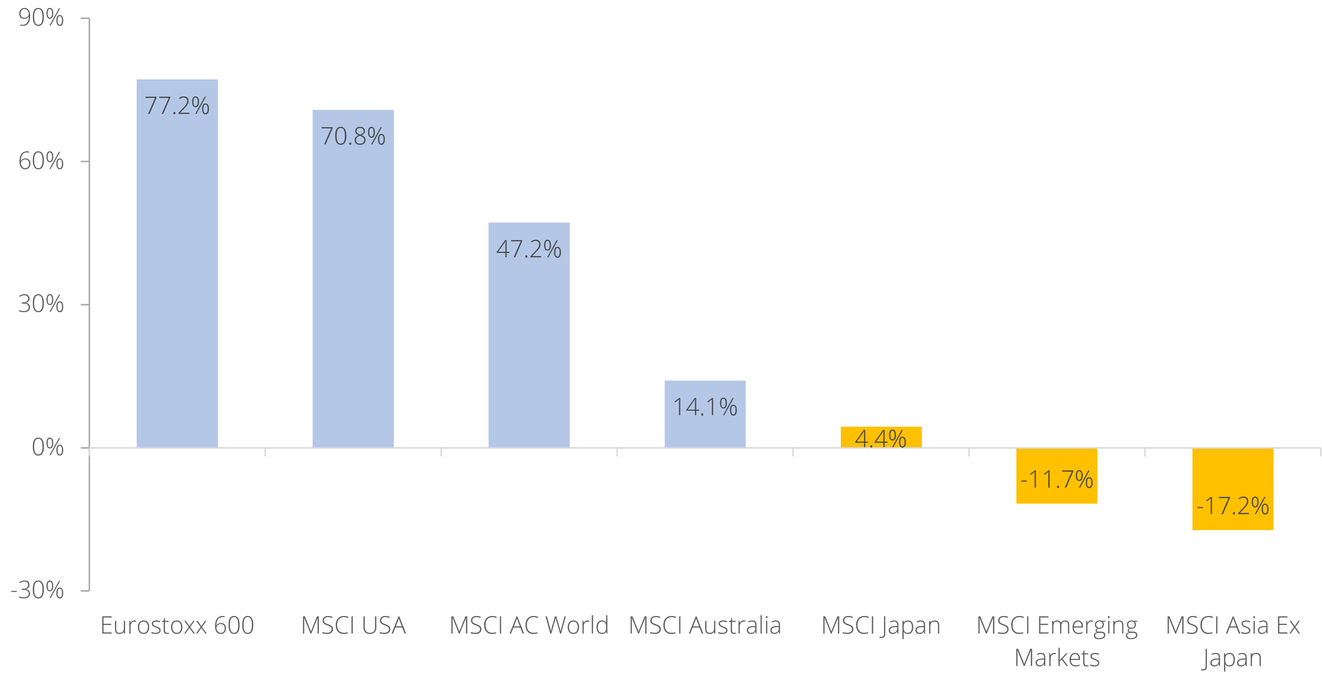
   The implications are twofold: investors may demand a discount to own equities (lower P/E) and returns to capital may fall. Whilst Trump is undeniably a break with the past, we would suggest caution calling the end of such a long trend just yet. US Mid-term elections are just four months away and could deliver a completely different political mix; Macron was elected in France and is implementing reforms; Millennials would seem to have strong preferences for the characteristics of globalisation, at the margin.

Figure 8 – US Yield Curve inversions & S&P500 (SPX) annual returns

FIRST INVERTED YIELD CURVE (PER YEAR)	SPX ANNUAL RETURN	SPX NEXT YEAR RETURN	SPX YEAR 2 ANNUAL RETURN	SPX YEAR 3 ANNUAL RETURN
18/08/1978	6.51%	18.52%	31.74%	-4.70%
2/01/1979	18.52%	31.74%	-4.70%	20.42%
2/01/1980	31.74%	-4.70%	20.42%	22.34%
2/01/1981	-4.70%	20.42%	22.34%	6.15%
14/01/1982	20.42%	22.34%	6.15%	31.24%
13/12/1988	16.54%	31.48%	-3.06%	30.23%
4/01/1989	31.48%	-3.06%	30.23%	7.49%
8/03/1990	-3.06%	30.23%	7.49%	9.97%
26/05/1998	28.34%	20.89%	-9.03%	-11.85%
2/02/2000	-9.03%	-11.85%	-21.97%	28.36%
27/12/2005	4.83%	15.61%	5.48%	-36.55%
31/01/2006	15.61%	5.48%	-36.55%	25.94%
2/01/2007	5.48%	-36.55%	25.94%	14.82%
Average	**12.51%**	**10.81%**	5.73%	11.07%
Median	**15.61%**	**18.52%**	6.15%	14.82%
Positive Percentage	76.92%	69.23%	61.54%	76.92%
Negative Percentage	23.08%	30.77%	38.46%	23.08%

Source: Stern

Figure 9 – Regional performance between January 1998 and December 1999



Source: Bloomberg, Team Analysis

3. **"The US is not the world."** One wrinkle, as alluded to in the Reflections on the Half, is that what works in the US may not work in the rest of the world. In the late 1990's, US stock market returns were excellent, but the tighter monetary policy of the USA arguably caused both the Asian crisis and the Russian default, leaving Emerging Markets investors with no net returns through the end of the cycle (**Figure 9**).

COURSE OF ACTION FOR 2H 2018

Positioning for a recession today based on a flat yield curve is unlikely to be a fruitful course of action for equity investors on a 1-year view. Bond market indicators continue to suggest the curve may invert in 2019, setting the US economy up for recession in 2020. **Figure 10** shows the date of the curve inverting based on futures pricing.

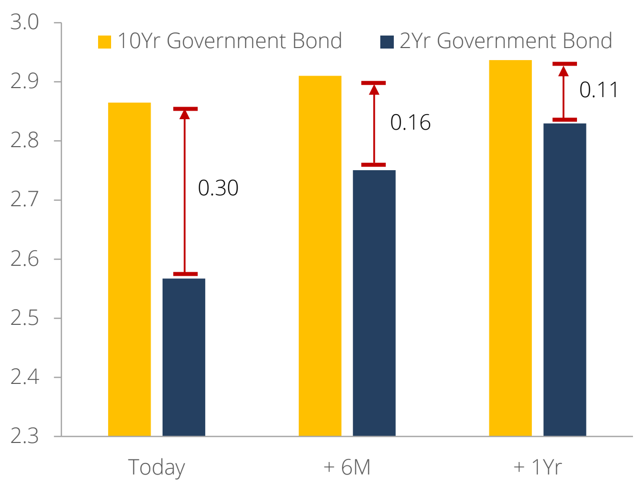
This would make sense as rates would have risen substantially with a further 4-6 rate hikes from now.

We anticipate a typical late cycle rally into equities through to then, with our conviction tempered by the concerns we raised earlier. Our optimism about Emerging Markets leading equity returns has been reduced by the reality of the last six months.

We thought the period of underperformance was done (circa 1997-98 in Asia) when we wrote in early 2018.

A focus on more market neutral positions with less region risk in Asia is arguably the best way forward in this scenario. Valuations in Japan are undemanding and companies continue to guide higher suggesting that as yet, they are not seeing changes in the economic landscape.

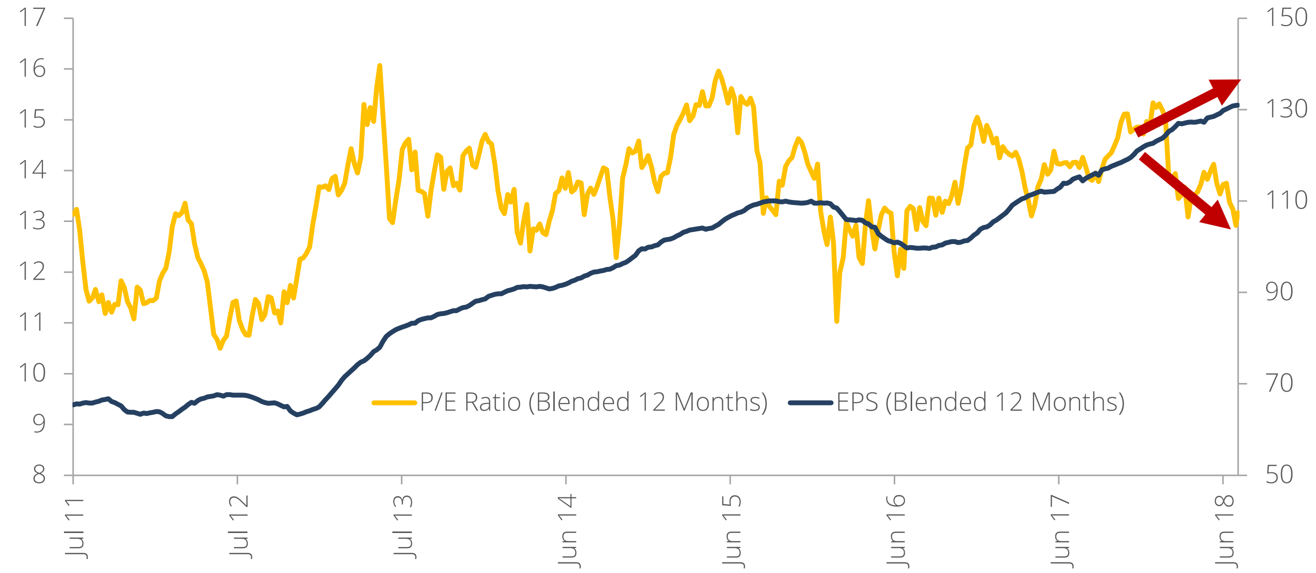
Figure 10 - Market implied Future US Bond Yields as at 10 July 2018



Source: Bloomberg, Team Analysis

Morphic
Asset Management

Figure 11 - Japan earnings & P/E multiples (July 2011 - June 2018)



Source: Bloomberg, Team Analysis

In **Figure 11**, one can see that the sell-off year-to-date has been driven by "Fear" rather than fundamentals. At a P/E of 12.9x, this is the level that Japan for example has found buying support in this cycle. We continue to find companies that are open to change on both fundamental and ESG levels.

And for the US Dollar, it will come down to whether the market thinks the Federal Reserve is "behind the curve" or "in front" on rate hikes and whether economies outside the US are growing faster or slower than the US. Chairman Jay Powell thus far has preferred to be in front (i.e. aggressive). We would thus say dollar strength is probably largely done, but without the conviction to call weakness just yet.

HOSTAGES TO FORTUNE: ANTI-PREDICTIONS FOR THE SECOND HALF OF 2018

> *There's only two kinds of actors - good ones and bad ones... and lucky ones and unlucky ones.*
>
> **Ian McShane**

As usual, we finish our report with a series of "non-predictions" for things we don't think will happen between now and December 31st, 2018.

BACK CHECK

First, we must reflect on the performance of our last set of "anti-forecasts" over this half that just ended.

European Banks will NOT be a graveyard for investors (Deutsche Bank to outperform World stocks)

Miss! The less said about this one the better as it's basically been wrong since the first day! An Italian political crisis, thrown into the mix of general European underperformance and some single stock issues, is a nasty recipe.

The Australian dollar will NOT go anywhere (vs USD plus or minus 3c).

Miss! Having started the year at 78c, we thought a range of 75-81c would hold. The 81c mark proved to be the high of January, but the low of 74c where it is now, is just wrong, but wrong nonetheless. Whilst there has been job growth, the wages just haven't come through and the RBA has remained on hold as the US rates rose. General risk off has pushed it to the low end of the range.

Global growth will NOT falter.

Hit! The global economic expansion is continuing. However, while 2017 ended with what looked like a synchronised upswing firing on all cylinders, this gave way in 2018 to the US looking like the strongest horse again. The US growth profile accelerated post Trump's tax changes while European and Asian economies data generally disappointed with softer data than expected.

Weak Australian consumers will NOT buckle the Australian economy.

Hit! Australian retail sales have remained soft without becoming weak. Consumers drew savings down and good exports saw a robust 3% growth rate for the Australian economy over the last 12 months.

Pakistan will NOT lose to India

Going for the video ref: Pakistan was leading handily over India for most of the half, but the trade war rhetoric of May and June and general risk aversion has seen this come back to being within 1% of where it started. A drawn test match?

2.5 out of 5 is not our best half, though if nothing else it does correlate with our (incorrect) positioning.

NEW VIEWS

We conclude this report looking at our predictions of what **WILL NOT** happen by December 31st, 2018.

US 10-year bond yields will NOT break above 3.50%

Even if the Fed hikes twice this year, US 10 years are unlikely to move much higher after a big sell-off earlier in the year. We think it suggests that the curve flattens even if the whole curve moves up a bit.

US Equity Markets (MSCI USA) will NOT finish lower

This is the historical outcome for equities of flattening but not inverted yield curve: higher EPS and bond yields that are more likely to go sideways rather than up, which all add up to a market that likely goes higher from here. The US market is chosen as it removes the choice of 1998 or 2006 scenarios.

US Investment Grade Credit will NOT go below its 2018 lows (JP Morgan Global Aggregate IG Credit Index Spread)

Without being a credit expert, this is a data point worth watching for equities. Credit should be the loser from being late in the cycle (higher Fed funds rates means more choice for investors who demand more premia for the risk). Even if we are wrong and a recession is nearer than we think, credit spreads do poorly in that scenario.

Trump's ratings will NOT collapse

For all the anti-Trump rhetoric globally, he has managed to hold his core voters near by controlling the narrative around his actions. His approval rating is around 42% showing a modest increase over the year. We don't expect this to decline significantly (<35%) in the second half. With his loyal home supporters behind him Trump can continue to turn the global order upside down.

Australian shares will NOT outperform global shares

With a local market dominated by overvalued banks, cyclical resource stocks and a retail duopoly, it is hard to see much upside. The ramifications of the Banking Royal Commission threaten to create a vicious cycle for an already sliding housing market, which will threaten consumer confidence. And there is no market B for Australian iron ore if China's slowing growth and emerging credit jitters persist. The feed through to a weak Australian dollar should make this a winner even if global equities have dull returns.

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 fed 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.

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.

Source: CFA Institute and Investopedia

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