2016: The year political establishments were put on notice

While the difficult markets that prevailed through most of calendar year 2015 continued into calendar 2016 and resulted in the ASX 200 plumbing a two-year low, it turned out that an inflection point was just around the corner. This is despite there still being plenty of dark clouds on the horizon, particularly in relation to China's economy and the potential for another financial crisis, with the February reporting season proving to be a positive catalyst for Australian equities.

The market

This is not to say that the ensuing rally was material, however the circa 15 percent gain in the ASX 200 from the multi-year low reached in February represented a reasonable achievement given there was no shortage of headwinds during the period. Key this regard was the run on global bank shares amid concerns that solvency levels were under threat from a combination of ultra-low (and in some instances negative) interest rates and overexposure to economic regions at risk of a financial crisis.

Source: Reuters

Although Australia's financials (which includes the banks) remained in relatively good shape, they were not immune to the weaker investor sentiment and continued to underperform the broader market despite also

recovering from the low point set in February 2016. This is in stark contrast to the ASX 200 Resources, which has been the key driver of the recovery in the ASX 200 since the low point reached in early 2016.

This of course was not a huge surprise to us, as we had been expecting commodity prices to recover through 2016 on the back of tighter supply and better-than-expected demand from China. This in combination with the Reserve Bank of Australia's decision to cut interest rates twice (i.e. once in May and another in August) to keep the Australian dollar competitive proved to be a positive mix for Australia's miners, which had spent the prior year or so ratcheting their respective cost base lower.

While we had expected the Reserve Bank of Australia to cut rates twice in 2016, our timing did prove to be a little off, with it taking three or so months longer for the country's central bank to swing into action. Nevertheless, we believe that it was a prudent move by the Reserve Bank of Australia, which was faced with the task of containing the risk of a potential bubble in Australian residential property prices while simultaneously re-balancing the domestic economy post the mining boom.

Source: Westpac Banking Corporation

The problem for the Reserve Bank of Australia is that the Australian economy is a small fish in a big pond. Consequently, and despite Australia's relative geographic isolation, what happens overseas has a huge impact on the country's economic performance. This was certainly the case in 2016, with the Australian dollar having remained stubbornly high (at least relative to the country's terms of trade) despite the Reserve Bank of Australia having cut rates twice during the period.

This was due largely to the fact that central banks globally remained committed to maintaining their respective interest rate at an ultra-low level to boost money supply, economic activity and ultimately inflation. That was at least until the 'surprise' (not to us!) election of Donald Trump as America's 45th President, which brought with it a marked transition from relying exclusively on monetary policy to what looks like being a more balanced approach (i.e. a combination of both monetary and fiscal stimulus).

The impact that Donald Trump's election has had thus far on global markets has been significant, to say the least. For evidence of this, Members need not look any further than US bond yields. While still significantly below their pre-GFC level, US bonds have been given a shot of adrenalin after it became clear that America's 45th President was intent on allocating around one trillion dollars of US public funds to fiscal stimulus measures, namely public infrastructure.

With the US economy having, albeit at a slower rate than many expected, gained momentum through 2016, it is perhaps not entirely surprising that Donald Trump's infrastructure investment plan was the icing on the cake for those seeking a catalyst for higher US inflation. The fact that the yield on US government bonds has been climbing ever since is indicative of this expectations, and as a consequence, the pressure this also places on the Federal Reserve to recalibrate US interest rates.

While this is not to say the double dissolution election in Australia, the Brexit vote in the UK as part of broader political instability in the EU and aggressive monetary stimulus in Japan have not been significant events for Australian equities, but rather that they have all been peripheral to what has been happening in the US, and to a lesser extent China. The reason for this is simple – US inflation and Chinese demand for commodities are most relevant to Australian equities.

This is because the prospect of higher US inflation will bring to a close the bull market in bonds that has been in place for a number of years now. While this is bad news for bond investors, it is great news for other asset classes, with the elephant in the room being equities. Add to this the fact that Chinese demand for commodities has remained better than many expected, and it is not difficult to see why Australian resources outperformed in 2016, and are likely to continue to do so in 2017.

However, as 2016 proved, there are risks to our expectation for buoyant Australian equities and resources and banks in particular in 2017. Key in this regard is political chaos, namely within Britain and the EU. While it is fair to say that these risks apply in any given year, we believe that the surprise election of Donald Trump vindicates our view that the Brexit vote was not a one-off event, with the comfort or risk-averse vote for the "same old" having been discarded in favour of the unknown.

The same can arguably be said for the Bank of Japan and OPEC, with both having arguably taken bold steps to address manage their respective issues. While the Bank of Japan, in concert with Japanese President Shinzo Abe, is steadfast in its commitment to reinflating the Japanese economy through whatever means possible, OPEC has been less than convincing with its move after an extended period of deliberation. Nonetheless, both have created investment opportunities in equities.

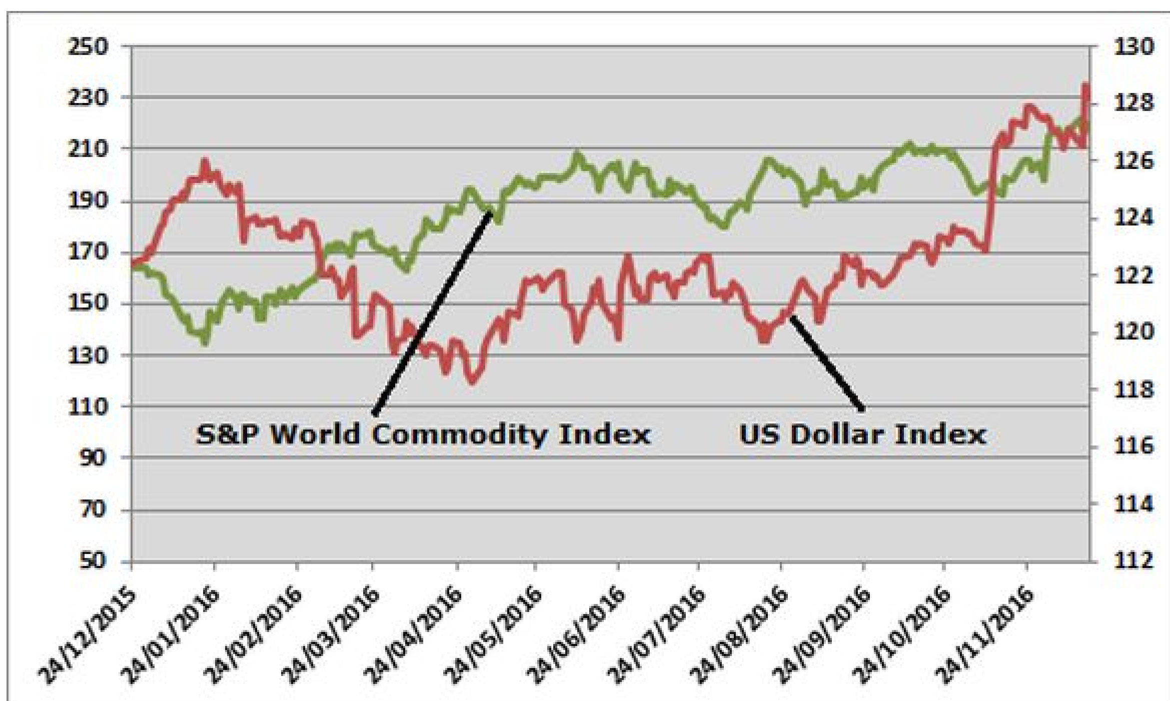
Ditto for the gold price, and precious metals generally, which has been symptomatic of the change in the Federal Reserve's rhetoric through the year, with the prospect of an impending tightening cycle having been supercharged by Donald Trump's plan to boost US investment in infrastructure. While the Federal Reserve's decision to raise its funds rate in December 2016 does justify the slump in the USD gold price since July 2016, further hikes are by no means a fait accompli.

Source: Reuters

<u>So to wrap up 2016 from a macro perspective, we think it is fair to say that it was a year when political establishments in general were put on notice, with the US having been the focus of global markets for most of the second half of the year.</u> With Donald Trump promising US$1 trillion of new infrastructure over ten years and the Federal Reserve seeking to keep US dollar strength from killing off what has been a fragile US economic recovery to date, all roads lead to higher inflation in 2017.

Resource Sector

The US Dollar played less of a prominent role in dominating commodity prices in 2016, as evidenced by a late lift in the US Dollar Index from mid-year. Broadly, across the commodities complex prices have finished the year on a high, as with the US Dollar Index. The following chart shows the S&P World Commodity Index and the US Dollar Index for 2016:



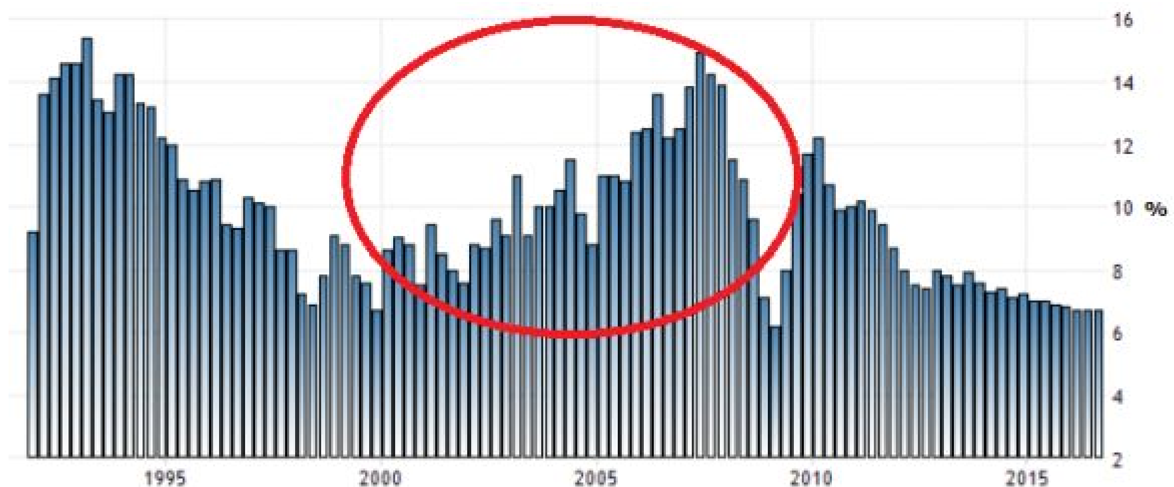
Sources: Standard&Poors and the Federal Reserve Bank of St Louis

The early euphoria of a weakening US Dollar, on a lack of action by the Federal Reserve (Fed) to lift US cash rates swiftly, punished the US dollar. The upward momentum in the US Dollar quickly returned however, on economic data sets that were becoming more positive. With the changing economic data sets came a change in market sentiment towards the view that cash rates would be lifted more quickly and apply upwards pressure on the US Dollar. **In fact, the Fed did at its final meeting for 2016 (Dec 13 and 14) lift the rate by a quarter of one percent, which immediately had a positive impact on the US Dollar and conversely a negative impact on commodity prices.**

It appeared therefore that late in 2016, commodity prices would go the way of 2015 and fall on a rising US Dollar. There was however one single defining event late in 2016; the result of the US Presidential election (the result was known on 8 November) which was won by the Republican Donald Trump.

What transpired on that day was a real boon for commodity prices, with a snippet from President-elect Donald Trumps' victory speech catching the market. He stated that he would **"renew US infrastructure"** and make it **"second to none."** The market suddenly saw commodity demand in the US firming as this programme is rolled out by the Trump administration and the US Dollars reverse correlation was broken. Infrastructure activity is a heavy user of commodities, so with estimates putting the cost of the programme in the range of US$4 trillion to US$5 trillion, **commodity prices reacted, going into the end of the year on highs.**

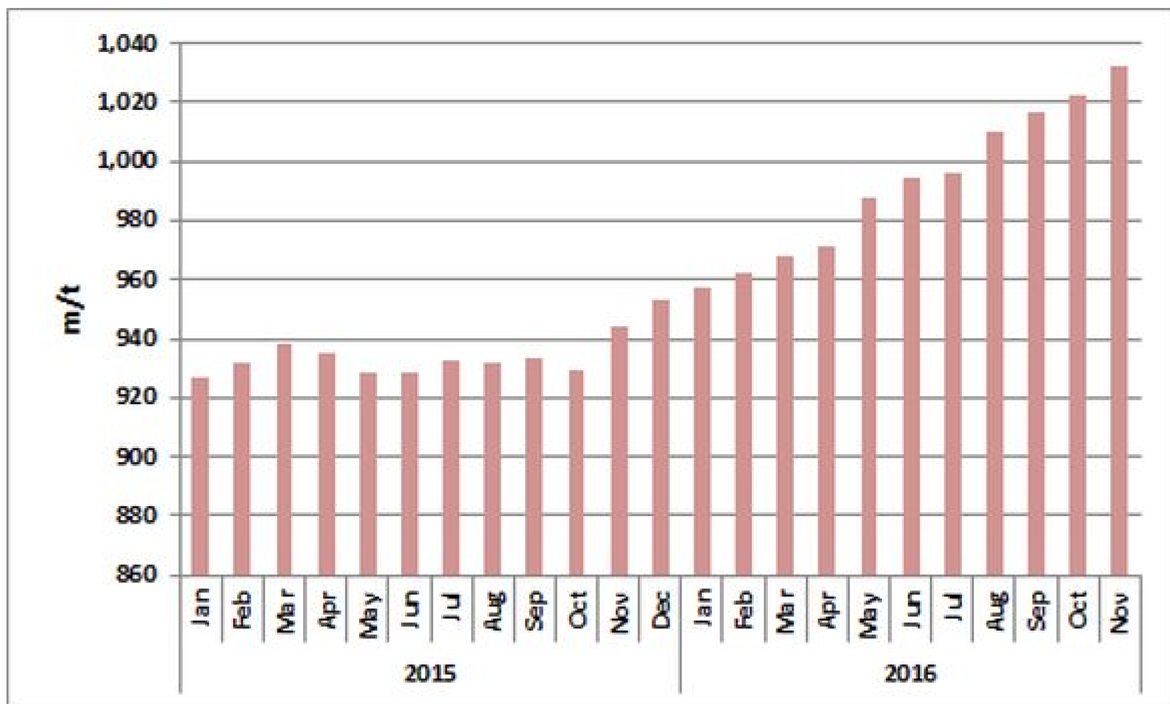
At last, the commodities complex had a potential second pressure point, with China the only one to that point, to influence prices. China had carried commodity prices, averting a real rout over a number of years on the back of its extraordinary economic growth, as highlighted in the following chart which shows year-on-year annual changes:



Source: Trading Economics

In 2016, China's growth was falling, and in doing so worried commodity markets about a hard landing, with economic data sets mudding the waters. Despite the inconclusive data sets, the sheer quantity of demand from by now a very large economy, continued to keep commodity prices from tanking in 2016.

An example of this phenomenon, in the year to November China imported a record quantity of iron ore as shown in the following chart:



Source: Chinese Trade

China's appetite for iron ore grew year-on-year to November by 12%, to a record 1.032 billion tonnes. The same appetite was biting across a number of commodities being imported into China.

A flight of development capital away from the resources sector, as resource companies battled the impact of low prices on their financials, started to come to the attention of markets. **Although supply deficits remain beyond 2016's sunset, for the number of commodities, the word "deficit" was starting to appear in the commentaries.**

We backed the Chinese appetite for commodities to be a major factor on 2016 price movements for commodities. **We were not far from the mark.**

In looking at our 2016 projections, we forecast West Texas Intermediate (WTI) to end the year in the range of US$50 to US$60 a barrel and it is currently trading at US$52.92 a barrel. Likewise for Brent, with the same forecast range as for WTI and is now trading at US$54.82 a barrel. We called iron ore to US$60 per tonne by the end of 2016, and we undershot the mark with it trading at US$81.22 a tonne.

On the base metals front we forecast copper to hit US$2.50 per pound and it is now trading at US$2.48 per pound, nickel in the range of US$4.00 to US$4.05 per pound and now trading at US$4.91 per pound to undershoot, and finally zinc in the range of US$0.87 to US$0.90 per pound now trading at US$1.17 per pound, again an undershot.

It is likely that at the end of 2015, when these forecast were set, we were in a minority group forecasting stronger commodity prices in 2016.

The research portfolio

Despite the market coming under pressure early in 2016, we remained mindful of the need for prudent portfolio management during the course of the year. We initiated sell or sell half recommendations 11 times in the Fat Prophets Australasian Equities Portfolio during the course of the year, with capital gains having been

reported in each instance – the one exception being Clydesdale Bank, which was spun out of National Australia Bank and thus had no entry price.

We have discussed in some detail the reasons for taking profits on the 11 stocks mentioned above in a separate report (refer to the report titles 'Where we took profits and losses in 2016' in FAT-AUS-804). 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 - we detail our investment methodology in our monthly Member workshops.

On the other side, we also introduced 8 new stocks to the Portfolio. Given that these additions to the Australian equities research portfolio are not mentioned elsewhere, we thought it would be worthwhile reiterating the reason(s) for their inclusion. Looking at the eight new stocks for 2016, we note that while there was no sector thematic, three of the stocks are New Zealand-based small caps, with the balance being Australian-based companies across the market cap spectrum.

Starting with the New Zealand-based stock additions, these include **9 Spokes International**, which is a business dashboard aggregator start-up that was added to the portfolio in October. In essence, we view 9 Spokes International's value proposition and dual distribution platform as having the potential to become a significant and disruptive force in the financial technology space over the next several years.

No unlike our investment view for 9 Spokes International, we view micro brewer **Moa Brewing Company** as another exciting start-up. While the business is more capital intensive than 9 Spokes International and similarly still loss making, there is still the potential for positive operating leverage as sales volumes grow and productivity rates improve. With a large and growing market and a somewhat unique customer proposition, it has been a case of so far so good for the investment case.

While certainly not a start-up, the third and final New Zealand-based addition to the Australian equities research portfolio in 2016 was **Michael Hill International**. Despite having subsequently issued a Sell-Half rating in September (we initiated with a Buy rating in May), this was due largely to the stock's positive performance during the period. Notwithstanding this, we continue to like Michael Hill International's fundamentals, with the store rollout plans being a key feature.

In terms of Australian-based stock additions to the equities research portfolio in 2016, these include **Sonic Healthcare**. While the company's shares have been a strong performer on both a relative and absolute basis, it has not been without its challenges, with this due largely to a reasonably volatile regulatory environment. This however is part and parcel of operating in an industry with attractive fundamentals and no shortage of growth opportunities, both acquired and organic.

While **FlexiGroup**, which is a financial services provider that operates in niche markets, also has the potential to generate significant growth by leveraging its core expertise in existing and new markets, this was not the key reason for its inclusion in the Australian equities research portfolio. In essence, FlexiGroup was added on the basis of its turnaround potential, which after a period of relative and absolute share price underperformance was not in our view adequately reflected in its market value.

Although arguably more speculative in nature, we also added Australian almonds producer **Select Harvest** to the Australian equities portfolio in mid-2016. As is the case with all agricultural companies, there are some inherent risks that need to be factored in to the investment case. While we did not pick the 52-week low, we

remain confident that Select Harvest's shares are worth considerably more than our entry price (i.e. $7.11 per share) on a through-the-cycle basis.

On the topic of speculative investments, while start-ups, agricultural companies and turnaround stories all rate reasonably high on the investment risk-o-meter, our decision to include **Fairfax Media** in the portfolio in 2016 was based on some rigorous fundamental analysis. It is for all intents and purposes a turnaround investment, however one that has a number of compelling features, not least of which is the strategic value inherent in its legacy assets, which is being ignored by the market.

Last but not least was real estate agency company **McGrath**, which was added to the Australian equities portfolio after a less than stellar debut on the Australian Stock Exchange. While there were some legitimate reasons (i.e. the company missed its prospectus forecasts) for McGrath's fall from grace shortly after its IPO, we viewed the underlying causes as being cyclical rather than structural and therefore considered the company's shares as being undervalued on a medium-term view.

Before moving on to our performance (i.e. investment returns on a relative and absolute basis) numbers for 2016, it is worth also considering some of the key Buy calls that we made in 2016 (and that remain in play). Focussing on the blue-chips, there are in our view three key Buy calls. In chronological order, these are ANZ Banking Group, which was upgraded to Buy in January 2016, and QBE Insurance and Telstra, which were both upgraded to Buy in November 2016.

While we remain positive on **ANZ Banking Group** for the same reasons that we cited in our upgrade note in FAT-AUS-756 (i.e. the upside from restructuring relative to its peers), the investment case has been strengthened somewhat by the recent election of Donald Trump as America's 45th President. While this positive tailwind (i.e. higher bond yields) is positive for banks in general, it supplements what remains a compelling investment case for ANZ Banking Group.

The prospect of higher US bond yields is also expected to be positive for the insurers, which have for some time now been weighed down by sub-par investment returns on the back of ultra-low interest rates and pricing pressure on insurance premiums as a result of increased money supply. Rising bond yields signal an end to these earnings headwinds for insurers – it is no coincidence in our view that **QBE Insurance's** share price has a high positive correlation with US bond yields.

In contrast, our decision to upgrade **Telstra** to a Buy is not based on the prospect of higher bond yields – in fact, higher bond yields are arguably a negative for Telstra given the effect this will ultimately have on funding costs and yield differential. However, with the Reserve Bank of Australia likely to let US inflation do the heavy lifting for the next 6-12 months, we expect Telstra's circa 6-6.5 percent fully franked dividend yield to continue to underpin the company's share price.

In this respect, Telstra is similar to the banks, in having a resilient earnings base (albeit with less pricing power), strong cash conversion, and an attractive dividend yield. While this is where the similarities end, it is worth noting that Telstra has embarked on a multi-year business transformation plan that is intended to reposition the company for the structural change being brought about by the NBN. It is early days, but we think Telstra has the expertise and capital to succeed in this regard.

The changes to our research coverage list and investment ratings are reflected in the Fat Prophets 'Income Portfolio', which has continued to generate robust returns. Key in this regard is the income yield since inception (as at 11 October 2016) in March 2012 of 18.5 percent, which is in addition to the capital growth of

23.6 percent. While the latter represents a modest underperformance of the ASX 200's comparable growth of 26.0 percent, this is not uncommon during a rising market.

Looking at the research portfolio more broadly, we note that performance-wise, the annualised return since inception on the Australian Equities Report stood at 18.7 percent (compared to 18.1 percent as at 30 September 2015), and compares favourably to the 7.6 percent gain in the All Ordinaries Accumulation Index over the same period. The one year calendar return this year meanwhile is on track to reach circa 22 percent by year-end.

The feedback from Members

If the results from our Member Survey for 2016 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. Included here are upgrades to the functionality of the Fat Prophets website, which has undergone further refinements to its design, navigation, layout and visuals within the Members area. We plan to continue making improvements here next year and beyond.

Our daily email also remains a vital part of our communication with Members and a channel through which we provide 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 the US election and US interest rates featured prominently in 2016, and will continue to be key discussion points in 2017, among other things.

Members also remain receptive towards our weekly fatWrap which summarises the best ideas from across the Fat Prophets suite of research products. We continue to put a lot of thought into our covers, and design, so it is pleasing that feedback here remains positive. Perhaps not surprisingly and consistent with our daily email, the key topics of interest in 2016 included the US election, the Federal Reserve and currency wars, oil, gold, Macau, Qantas, Brexit, and the Federal election.

Encouragingly for us, the Member Survey for 2016 confirms that 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, on 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 very positive.

In response to Member demand we also made some changes to our product suite. Key in this regard in 2016 was the launch of a weekly European Equities report in February 2016. Not unlike our decision in the prior year to launch an Asian report and Global Funds report, the key rationale for doing so is to provide Members with what we believe are the best investment opportunities in each instance.

So we conclude that despite a volatile, if not challenging year for markets, the positive feedback from our annual survey suggests that our efforts to boost Member returns and deliver a high quality service have generally been well received. This has culminated in our efforts having been awarded an 'A' grade from Members this year, compared to the 'A-' that we received last year. Accordingly, we once again like to thank those Members that took the time to provide feedback for this review.

The end

On behalf of Fat Prophets, the research team would like to wish you all a Merry Christmas and a happy New Year. We will be publishing our predictions for 2017 in the next report (i.e. FAT-AUS-805) on the 10th January 2017. As is usually the case, these predictions will cover a range of topics. While the focus will be primarily in predictions for global financial markets, it will also venture into the murky world of politics, geopolitics, sport, rock stars and royalty.

Signing off on 2016, 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: Fat Prophets holds an interest in 9 Spokes International, Moa Brewing Company, Michael Hill International, Sonic Healthcare, FlexiGroup, Select Harvest, Fairfax Media, McGrath, ANZ Banking Group, QBE Insurance, and Telstra.

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SLR, SPK, STO, SUN, SYD, TAM, TLS, TME, TPM, VOC, WBC, WFD, WES, WHC, WOW, WPL, WSA. International stocks: Activision Blizzard, Alibaba Group, Amadeus IT, Apple, Arcos Dorados, Bank of China, Barrick Gold, Baidu, BNP Paribas, BP, Caixabank, China Life Insurance, China Mobile, China Overseas Land & Investment, China Taiping, China Vanke, Cisco Systems, Citigroup, Coeur, Corning Inc., Country Garden, Credit Agricole, Credit Suisse, D.R. Horton, Dai-Ichi Life Holdings, Daikin Industries, Danone, Dr. Reddys Laboratories, ENAV, Euronext, Fanuc, FedEx, Fresnillo, Fukuoka Financial Group, Glanbia, Google (Alphabet), Heidelberg Cement, Heineken, ICICI Bank, Inpex Corporation, James Hardie, KONE Corp., Lennar Corp., LVMH, MGM China, Mitsubishi Corp., Mitsubishi UFJ, Mitsui Fudosan, Mizuho Financial Group, Nintendo, Nippon Telegraph and Telephone, Nissha Printing Co., Nomura Holdings, Panasonic, PICC Property & Casualty, Powerhouse Energy, PPHE Hotel Group, Randgold Resources, Reliance Industries, Resona Holdings, Riverstone, Royal Dutch Shell, Sands China, Societe Generale, Sony Corporation, SPDR Gold Trust ETF, Square Enix, Sumitomo Chemical, Sumitomo Mitsui Financial Group, Tata Motors, TE Connectivity, Telepizza, Tencent, THK Co., Toyota Motor, VanEck Vectors Junior Gold Miners ETF, Volkswagen, Walt Disney, Wynn Macau, Wynn Resorts, XTD, Yaskawa Electric, Zillow. These may change without notice and should not be taken as recommendations.

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