JCP Investment Partners – Market Outlook 2019

January 2019

Introduction

2018 was a volatile year for global equity markets. In Australia, the volatility arrived late in the year with the December quarter recording -9.7% (All Ordinaries). The correction in the December quarter saw the Australian equity market finish -7.4% (All Ordinaries) for the calendar year, underperforming US markets. The best performing sector was Healthcare +17%, while the worst performing sector was Telecommunications -21%.

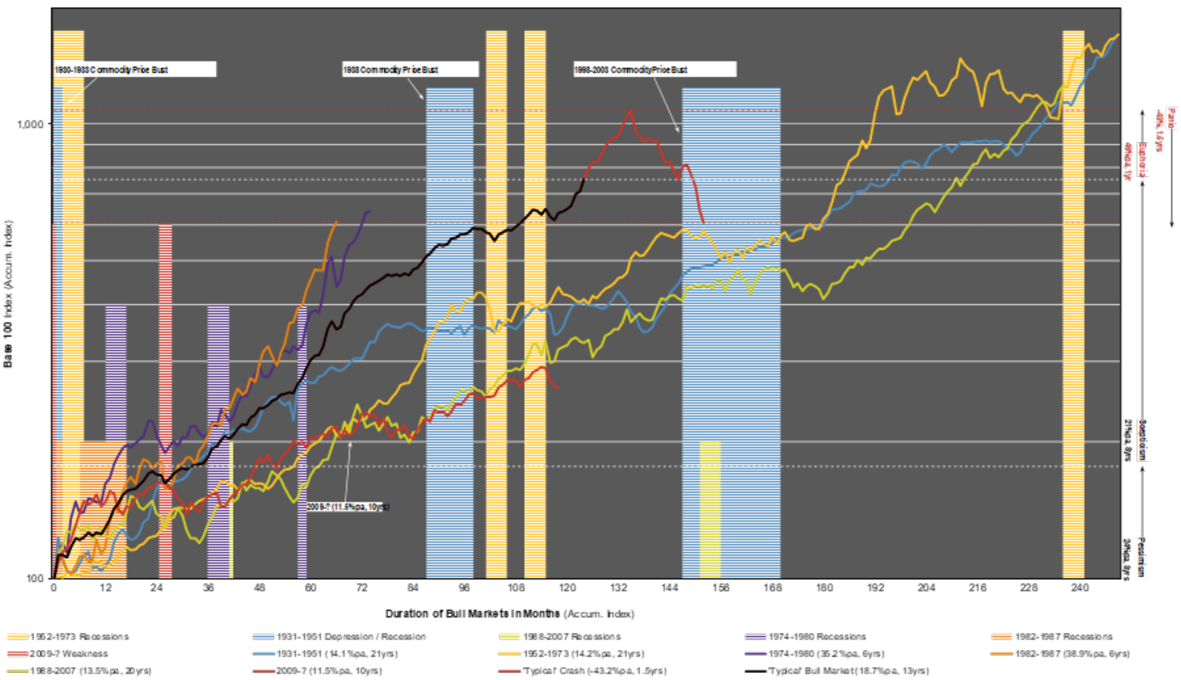
Global markets were also weak, particularly late in the year. US markets saw all three indexes record negative returns for the year, (Dow (-5.6%), S&P 500 (-6.2%) and Nasdaq (-3.9%)) after posting major corrections of between -12-17% in the December quarter on concerns of a global growth slowdown, fears that higher US interest rates may lead to a recession and soft data out of China.

Europe also posted poor returns for the year, with the UK -12.5% as Theresa May's decision to postpone the vote on her Brexit withdrawal agreement seeing stocks fall. Germany (-18.3%) and France (-10.9%) also delivered double digit negative returns. In Asia, Hong Kong (-13.6%) and Japan (-12.1%) also performed poorly, while the Chinese market was substantially lower (Shanghai Composite: -25%), reflecting continued uncertainty over their growth outlook and implications for their economy from a trade war.

Our 2019 forecast for the Australian All Ordinaries Price Index is for a capital return of +5% (versus our expected equilibrium capital return of +5% and a dividend return of 5.4%). Our 2019 forecast incorporates our view that the market is currently under-priced by about 4% after its sizable fall over the last four months of 2018, and that about one-third of this over-pricing will retrace this year.

Despite our view of only a moderate capital return over the next 12 months, given that we see the Australian market as slightly cheap from a bottom-up perspective, longer-term we remain bullish given we think there is still further to run in this bull market cycle despite potentially more severe corrections as the cycle matures (see chart below). The improved value now on offer, combined with a backdrop of interest rates (while heading higher) remaining at historically low levels and an inflationary environment of 2-4%, should be positive for equities, sowing the seeds for the continuation of this bull market post the recent correction. We expect the environment to be positive for equities until interest rates become more restrictive on the economy. We also continue to see Australia as a laggard to global markets.

Australian Bull Markets



The post-2009 Australian bull market appears to be following a similar pattern the '**great moderation**' bull market from 1988 to 2007; and the '**golden age**' (from 1952 to 1973) and '**post-depression**' (from 1931 to 1951) bull markets. The compound average annual return for the post-2009 bull market has been 11.5 % p.a. over nine years; compared to 13.5% p.a., 14.2% p.a., and 14.1% p.a., respectively for these earlier bull markets. So, its Australia's weakest bull market ever, perhaps explained by current low inflation.

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After writing about the impending weakness in the domestic economy for several years we feel Australia's day of reckoning has finally arrived. Property prices are falling at an alarming rate as we speak with no signs of bottoming and the support from foreign buyers has rapidly evaporated. The wealth effect from falling property prices will be a key driver of stock performance in 2019. We expect those companies and sectors exposed to offshore earnings or exports to do relatively better than those exposed to the domestic economy. Downside pressures continue to build on the Australian dollar in 2019 as Australia's negative yield differential (versus the US Fed funds rate) potentially gets more negative with one or two further increases by the Fed expected during CY2019 and a possible interest rate cut by the RBA if house prices continue to fall.

However, mining commodity exporters may not benefit as much from a weaker dollar as other exporters and offshore earners because the outlook for Chinese growth and commodity prices in 2019 will be more uncertain with risk skewed to the downside. Domestic industrials will continue to face a challenging environment particularly those exposed to the Australian household sector and technological disruption. Unless household income growth recovers in 2019, household consumption growth will continue to weaken due to falling household wealth. Banks will face increasing challenges from decreased credit growth driven by falling house prices and tighter regulatory controls (especially related to Responsible Lending), NIM pressures from weaker deposit growth and rising wholesale interest rate spreads, and negatively skewed capital risk from increasing bad debts.

Topics of interest at JCP in 2019

There are several areas of analysis that have stirred debate at JCP as we head in to 2019. Each appears to carry a bit more bite that in standard years.

We traditionally discuss the issues of the day in terms of the domestic conditions and expectations, an outlook for the US and the rest of the world. In this year's outlook we will introduce information on all three but within a broader discussion, interceded with concrete examples of how each issue impacts your portfolio, and how our process incorporates the issues.

We will often return to the issues of skew and risk, because it is our view that only through identifying risk and skew, we can explain the sizing and sustainability of key portfolio positions.

1. **Technology, innovation and creative destruction:** We continue to see a fantastic level of innovation and technological change. A 2019 outlook statement give us an opportunity to take stock of the slower processes of innovation and change that dominates our day-to-day analysis of stocks over the course of a year. Great companies are constantly innovating, and a rare few both innovate and increase their ROIC in doing so. Not all innovation needs to change the world to create significant value for listed companies.

2. **The economic consequences of falling Australian household wealth and the impact of the Australian Royal Commission**: What impact will falling credit growth have on house prices, the household savings rate, and consequently household consumption, economic growth and employment? What's the chance that Australia experiences an adverse credit cycle and a banking crisis? What will the recommendations of the Royal Commission mean for bank profitability due to lower credit growth, higher regulatory costs, and changes to bank behaviour when dealing with customers?

3. **The removal of global monetary stimulus**: We consider the removal of global monetary stimulus and the implications for markets. Across the US Fed reducing its balance sheet and raising rates, through to Europe and indirectly in China, global money growth is retreating in an environment of weak inflation and high asset prices. Will liquidity and fiat stimulus retreat, what growth model could replace it? For whom would this make sense? Or does the sheer quantum of debt mean the opportunity to "normalise" proves ephemeral. 2019 will provide some clues.

4. **China's economic challenges**: How does China juggle a weakening economy, debt reduction, economic reforms, and an escalating trade war with the US; while avoiding a major collapse of asset values which generates an adverse credit and business cycle (i.e., a Minsky moment)?

Technology, innovation and creative destruction:

Beginning on a positive note, we continue to see a fantastic level of innovation and technological change. An outlook statement gives us an opportunity to take stock of the slower processes of innovation and change that dominates our day-to-day analysis of stocks.

In the face of the following, we need to identify innovation early and value it well;

- Technology continues to undermine existing business models, each year we find the market underestimates the impact of structural changes in key areas.
- Uncertain future for long-term rates, if rates remain low, the value of future growth will remain expensive. Technology and innovation are a hedge to a higher rates view.
- In a period in which Australian households are under pressure, we are looking beyond the domestic economy, innovation often provides a broader global platform.
- On the other hand, Australia is arguably better equipped than average to generate opportunities in innovation that belie our otherwise narrow economic focus, and market index.
- In a world in which geopolitical tensions are rising, the value of technological advantage is amplified, given current access to global pools of knowledge may not remain low-cost or open.
- In some areas such as health and alternative energy and storage (including batteries), the prize for success or costs of inaction remains so large, that the hurdle rate for investment remains very low.

Great companies are constantly innovating, and a rare few both innovate and increase their ROIC in doing so. Not all innovation needs to change the world to create significant value for listed companies. We have chosen to list several topics, not all equal importance, that are occupying our time and just some of the listed companies that are impacted. Some may only be small caps, and some trends are tangential, but for a number, 2019 will prove very important.

5G and the explosion of mobile, will impact the market on many levels. The movement of the internet and web-based services to mobile platforms has progressed so far. The emergence of 5G will only strengthen and deepen the integration of cloud-based computing into everyday life. **Cloud based services** are now the minimum expectations we have for mature company's product offerings. Increases in demand are impacting data-centre providers such as NextDC (NXT), and infrastructure providers such as Telstra (TLS), Superloop (SLC) and Vocus Communications (VOC). Who ultimately builds the nations 5G solutions, with whose equipment, and possibly partnered with others, remains a critical question for TPG (TPM). At the software level, the expansion in cloud-based solutions will drive significant demand for "virtual" scale in the cloud. Megaport (MP1) is a company innovating in the backbone of the software layer that navigates these connections.

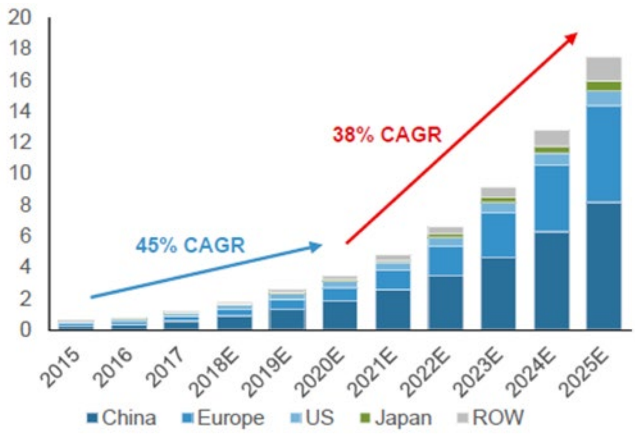
We suspect that 5G will not only change the speed of telecommunications, but the type of services provided, including a vast expansion of the **Internet of Things (IoT)**. Companies which may prove important in processing this new array of information would include the first generation of machine learning based business such as Appen (APX) and Straker (STG). These businesses facilitate others innovation, we expect a range of existing business being able to explain how machine learning is improving current operations.

Machine learning may prove revolutionary, seeing existing companies fail. We suspect; however, many existing companies access to their own data will strengthen their position, through either market power or pure innovation. Companies that can combine strong market position with innovation, and the power of network effects is compelling in this environment, examples include Xero (XRO) and Carsales (CAR). Those without great network effect positions, especially oligopolies such as Woolworths (WOW), will still have the scale and capacity to cement their position with data, even if it won't necessarily increase returns.

Even if 5G only increases the speed of mobile services it will have a big impact in media, accelerating the already rapid evolution in the delivery of **over-the-top (OOT) entertainment services**. The consolidation of the role of Netflix in Australian households, the emergence of Kayo, a new Fox Sports product, the promise of Stan with Disney and likely offers from other players will continue to change domestic media in 2019. Positions in News Corporation (NWS) are likely to benefit in 2019.

Batteries and their supply chain; a core theme of 2018 remains important as the entire world begins to organise around different materials, manufacturing locations and partnerships. Australian assets appear well placed to exploit this emerging area. The breadth of individual materials (lithium, nickel, cobalt, copper, vanadium, graphite and manganese) provide tailwinds to a wide variety of stocks, meaning the battery thematic remains an important component of our portfolios. At the less exciting end, changes in production techniques and improving efficiency remain critical for a variety of marginal producers and unlocking changes that work continues to create significant value. Western Australia will quickly become a key geographical location for the supply and processing of lithium with significant amounts of capital being deployed.

Global Electric Vehicle Sales by Region (m units)



Source: UBS

In **heath**, the constant evolution of cancer drugs as they become more personalised present new investment opportunities. For the market's largest biotech companies CSL, Hizentra recently gained regulatory approval for CIDP patients. CIDP patients make up a significant share of total IVIG usage and given Hizentra is the only subcutaneous IG approved for CIDP patients we believe CSL is well placed to take share in this market. We also believe CSL's cell-based flu vaccine is exciting. Recent data has shown better efficacy compared to traditional vaccines, and furthermore, the manufacturing process is also much more favourable.

Caring for patients better that are already in the system remains an area of future growth, one that Australasia appears to excel at. Companies like Fisher and Paykel Health (FPH) or Nanosonics (NAN) improve critical hospital outcomes and have developed global markets. On a more mundane level the proliferation of NDIS and in home aged-care solutions in Australia are presenting new business opportunities.

Another area that the market tends to bemoan the pace of change, **agriculture**, is making huge steps (relatively). Changes in agricultural product supply chains continue to develop – Freedom Foods (FNP), Costa Group (CGC) and others are presenting a corporate solution to a global market. At the same time, these companies are also innovating in modes of production and product development. In the coming year we suspect that building the early successes in these supply chains will position these types of companies well, when more rapid innovation in digital supply chains, agricultural efficiency, soil science, robotics and machine learning impact agriculture.

Another area of expected innovation is **fintech**. The price in fintech is apparent to all, but finance, unlike pure retail for instance, is bound by some simple facts, it needs to lend well, and lend sustainably. Unfortunately, current offerings such as Afterpay (APT) have fallen short of our expectations on a range of ESG issues. But in a post Royal Commission environment we expect new opportunities for growth to emerge.

And finally, in **retail** we are seeing the costs and benefits of change impacting all areas, pressures on cash rent paid is only accelerating, large businesses are delivering online and click and collect solutions almost regardless of the cost, the new data rich connection to customers are becoming standard practice. Our large supermarkets are well placed to invest and defend, whilst all JCP portfolios remain underweight retail REITs.

Finding a good entry price for this type of technology driven growth, valuating the options for existing companies, and quantifying both the downside skew of model obsolescence versus the upside skew of process enhancement and new product development remains the challenge for 2019.

In summary, the JCP portfolios have positions in a number of stocks that have structural growth potential from exploiting technology changes, innovation and the process of creative destruction.

The economic consequences of falling Australian household wealth & the impact of the Australian Royal Commission

One of the most important of events of 2018 in Australia was the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry. In January 2018 we asked, *will a Royal Commission into Banking uncover endemic problems with loan quality?* Combined with revelations on the use of HEM, interest only loans and weak governance procedures, it is now clear there was endemic problems with loan quality, and broader financial products and behaviours throughout the finance industry.

At JCP, we consider whether a debt super cycle lasting for two decades, responsible for sustained growth in Australian household debt to income ratios, skyrocketing asset prices, and an economy in which money supply growth was driven by mortgage growth, can simply deflate? Can growth pivot once more?. Or does Australia face a more significant reckoning? To these questions, we continue to see the risks as asymmetric to the downside.

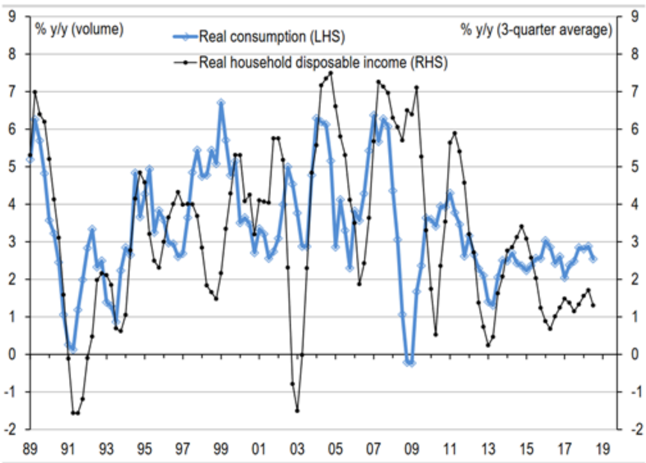
Across the range of JCP portfolios, we remain underweight domestic cyclicals. In higher risk portfolios the bank underweight position is more pronounced.

The significant negative skew that emerges for bank equity from downside scenarios is critical. These scenarios concentrate on a bad debt cycle created by a sustained downturn in credit growth, and its transmission to the broader economy. We are firm in our view that without new and significant sources of new money supply, the retrenchment of demand implied by slowing or negative credit growth, and its feedback into higher savings, and weaker demand is not priced in the current market.

Is there any evidence for our view on the cyclical downturn? Yes, a lot. We would point to weakening savings rates, slowing loan growth, soft retail sales and cratering new car sales. A range of downgrades from property developers, construction companies and those involved with mortgage origination provides further support.

The possibility of further transmission needs to be analysed in terms of current conditions. Despite huge population growth, weakening conditions are still supported by total consumption growth in excess of income growth – declining savings. For households to merely seek to redress the current worsening imbalance, aggregate demand would fall. The chart below shows the gap between income growth and consumption has sustained higher growth for almost 3 years. But this was in a period of rising asset price and improving credit.

Australia – Household Consumption vs Income

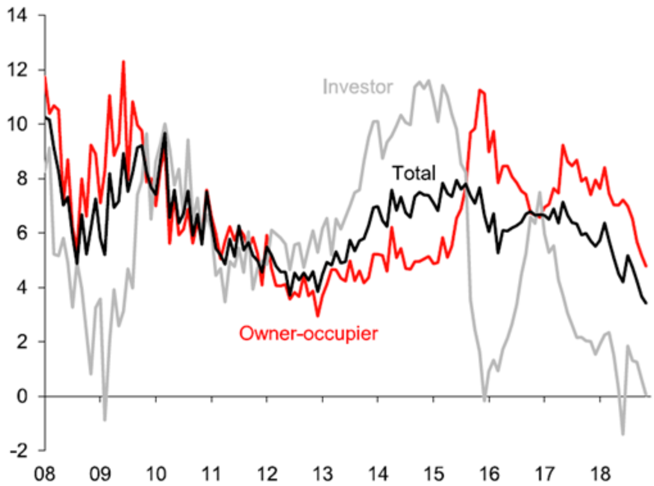


Source: UBS

Credit growth shrinking

Changes to bank behaviour have created a dramatic, and as at the time of writing, accelerating, reduction in the availability of credit, with growth in household credit continuing to slow to an annualised monthly rate of 3.4%pa.

Australia - Housing Credit Growth (monthly, annualised)



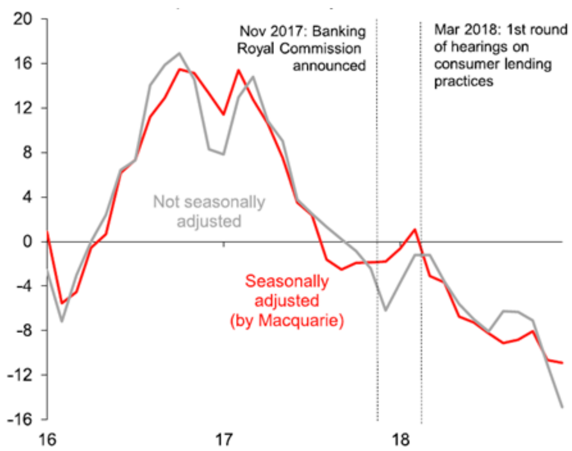
Source: Macquarie

The first policy response has already arrived, with APRA removing the caps on interest-only loans. However, actual demand for such products is much lower, and the RBA Governor has given banks a 'pep-talk' about not reducing credit growth too much. But both interventions assume a surplus of demand, however interest only loans are currently far below the cap, and major banks are already willing to cede market share to the non-majors, even in a slowing market. Both measures will have limited impact without a pick up in the spirits of the household sector.

House prices falling

House prices are primarily a function of the availability of credit, and hence have begun to fall in major cities and, in places, price falls are accelerating. CoreLogic's 5-capital-city dwelling price series declined 1.3% m-o-m in December 2018, or an annualised monthly decline of 15%.

Australia – Dwelling Price Growth (5 capital cities, monthly, annualised)



Source: Macquarie

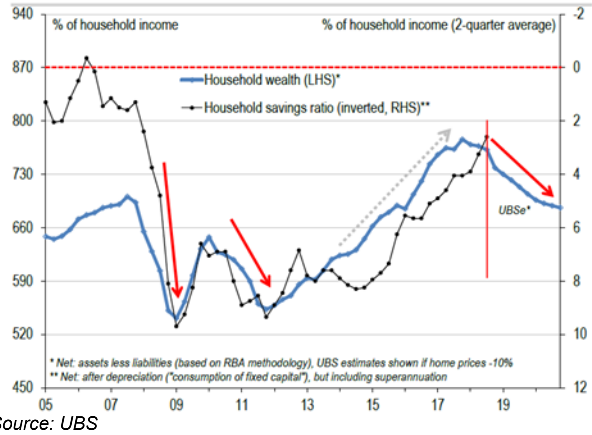
So today the market struggles with a simple idea – how much money did we lend to people who couldn't afford it, what is the impact on those households, and what is the impact on the economy if we only lend to those than can afford it going forward?

Is credit growth falling because of more restrictive supply of credit (e.g., the impact of the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry), or because of lower demand for credit due to marginal capital flows out of housing (especial Sydney and Melbourne) resulting in falling prices? If it's the former, then regulatory pressures could be eased in the short-term to allow the banks to lend more freely. However, the latter is more problematic and may require government intervention (e.g., an increase in population growth, higher housing subsidies, etc.).

Impact on household wealth, savings rate, consumption, economic growth and employment

Given that household wealth was still rising in Q3-2018, the negative 'household wealth effect' is yet to hit consumption.

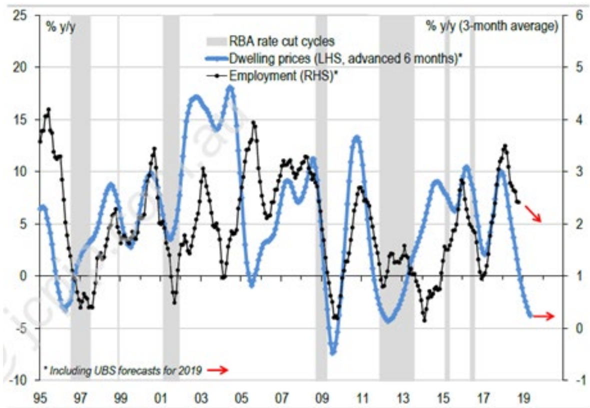
Australia – Household Wealth and Savings



Source: UBS

Based on historical data, a fall in household wealth effect would be expected to stop the household saving ratio from falling further and cause it to increase (see above chart) with a consequential negative lagged (~6mth) impact on consumption, economic growth and employment (see below chart).

Australia – Dwelling Prices and Employment



Source: UBS

With the negative feedback loop explained above, households need one of three things, preferably all. The first is clearly access to credit they can afford. The second is growing levels of wealth - we remain of the view that households substitute capital or wealth gains for savings from income and deferred consumption when they are confident. The third is a widely held view of stronger future growth that households are willing to "bring forward" in terms of current consumption.

We also expect a policy response from the Government (e.g., more infrastructure investment, a bring-forward of income tax cuts, and increasing immigration) and the RBA (a 25-50bps OCR cut). However, the former brings the risk of a credit rating downgrade and higher borrowing rates, while the later risks a currency collapse and higher inflation ultimately leading to subsequent rate increases.

The impact of the Royal Commission

The Final Report from the Royal Commission is due on 1st February 2019. Given the line of questioning of CEOs, Chairmen and regulators Commissioner Hayne will recommend substantial changes for the banking sector.

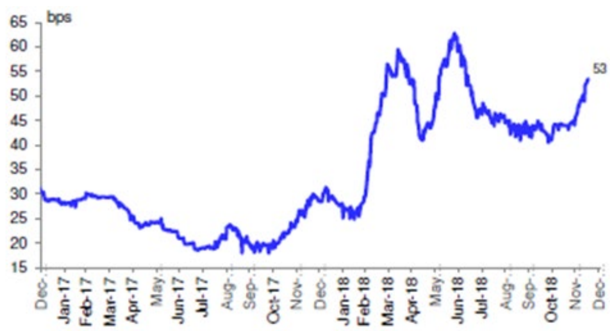
The likely negative impact from recommendations (especially in relation to Responsible Lending), tightening funding markets, and falling housing prices are likely to negatively impact the growth in bank loans and put downward pressure on NIMs. With negative asymmetric risk around a credit crunch and therefore capital risk, the environment for the Australian banking sector seems at best, very challenging.

We still think the chances of an adverse credit cycle and banking crisis in Australia are around 40-50%, with the consequential large negative impact on the Australian economy and economically sensitive sectors. Therefore, JCP portfolios continue to remain underweight Australian banks, consumer discretionary stocks and domestic retail REITs.

Bank funding costs

One other area we are paying close attention to is bank funding costs. Since November the key indicators of wholesale funding costs have deteriorated.

Australia – 90 Day bank bills vs OIS Spread



Source: Deutsche Bank

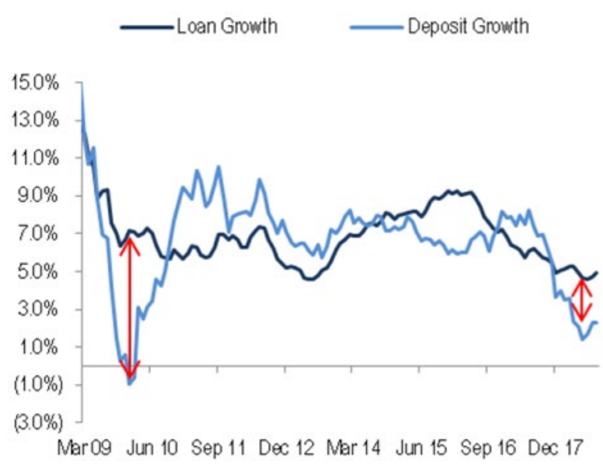
The bank bill-OIS spread has increased, reaching 53bps. Increasing funding costs would ordinarily be passed on but given the extent of household debt we think this is increasingly challenging without causing distress.

Historically, the BBSW/OIS spread has largely moved in line with global counterpart spreads such as the US LIBOR/OIS spread. As the US spread moderated in May 2018, most market participants expected that the Australian OIS spread would begin to head lower. However, the reverse has occurred, suggesting the domestic BBSW/OIS moves are more structural and likely to be linked to specific domestic issues. (For example, the Royal Comission, an increasing funding gap between loans and deposits, a spread reversal between the Fed funds rate and the RBA OCR, etc.).

The divergence of US and Australian central bank rates is likely to continue to push short-term funding away from Australia, which is needed to support the mortgage market. One of the medium-term challenges for the Australian financial system is the ability to continue to attract offshore debt to fund the AUD$1.7bn mortgage market. Historically, Australia has had higher rates to attract global funds in search of better returns.

Further impacting bank funding, a falling household saving rate is driving a gap between total domestic loans and total domestic deposits on bank balance sheets. At the same time as the USD/AUD official rate spread gets more negative the household saving rate is falling and reducing domestic deposit growth.

Australia – Loan Growth vs Deposit Growth



Source: Citi

In summary, we believe Australian economic growth will continue to fall in 2019, weighed down by an increase in the household savings rate due to falling household wealth and resulting weaker household consumption growth. We also expect some policy stimulus from the Government and RBA to avoid an economic recession; but the risks are skewed to the downside, especially if there is a Minsky moment in China or the US lifts interest rates more than expected.

The JCP portfolios have relatively low exposure to Australian focussed businesses; and with domestic exposure held in defensive businesses (consumer staples, utilities, insurance, hospitals) and structural growth internet software & services businesses.

The removal of global monetary stimulus

At JCP, we consider the removal of global monetary stimulus and the implications for markets.

From the US Fed reducing its balance sheet and raising rates, through to Europe and indirectly in China, global money growth is retreating in an environment of weak inflation and high asset prices. As liquidity excesses and fiat stimulus retreats, what growth model could or should replace it? For whom would this new model make sense? Or does the sheer quantum of debt mean the opportunity to “normalise” proves ephemeral. 2019 will provide some clues.

Our base case remains that the US will prove normalisation of interest rates is possible. Labour shortages, innovation and the promise of future capital investment may provide strong enough nominal conditions for normalisation to be delivered without a collapse in growth.

In this environment, any mix of growth (even moderate) and sustainable cash flows will provide reasonable returns in the Australian market. In an economy, constrained by household debt, and driven by external demand and government spending, the challenge will remain finding the combination of companies that;

- invest well incrementally, and at least arm themselves with optionality;
- exploit existing market structure advantages;
- whose growth can be exogenous to weaker domestic conditions;
- and can avoid the risk of Chinese growth, and geopolitical tensions

We believe that our portfolios, across a range of risk profiles, offer exposure to these conditions.

The US Federal Reserve’s interest rate trajectory

More specifically, the US Fed’s interest rate trajectory requires some discussion given its impact on Australian funding, exchange rates and market dynamics. How many more interest rate increases will the Fed need to get back to ‘neutral’ and what impact will these rate increases have on global liquidity and asset prices; and more specifically the AUD/USD FX rate if Australian terms of trade fall due to weakening demand for key export commodities?

There are two important US interest rate questions that financial markets are currently grappling with:

1. What is the FOMC view of the ‘neutral’ level of Fed funds rate?
2. What will be the cyclical pathway of the actual rate relative to this neutral rate?

Given commentary from the Fed, it is reasonable to assume that the FOMC currently views the neutral Fed funds rate to be between 2.5% and 3.0%. Therefore, given the increase in the Fed fund rate on the 19th September to 2.25%-2.50%, the current rate is just below neutral.

Regarding the cyclical pathway of the actual Fed funds rate, at his Press Conference on 19th December 2018, Chairman Powell stated that, “…the U.S. economy has continued to perform well, roughly in line with our expectations.”

US recession?

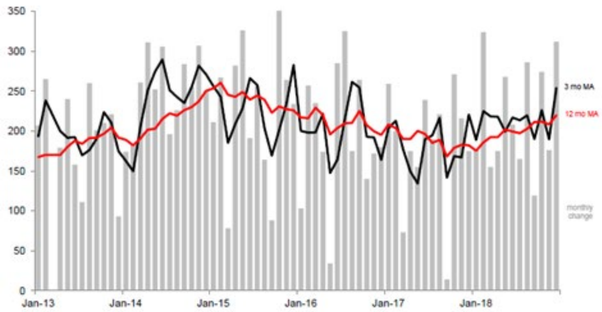
Discussion of a US recession feels disjointed. An obsession with a cycle, and the constant search for a “turning point” has reached new levels of fervour. After 27 years of expansion in Australia, we are potentially more aware of pitfalls of constantly predicting recessions.

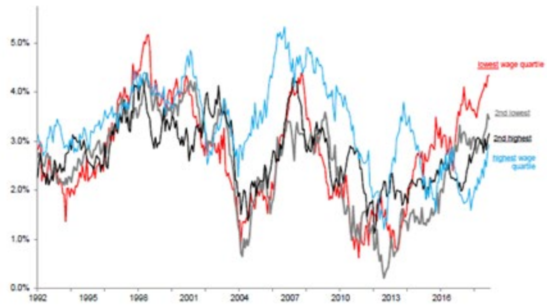
As stated previously, we are of the view that the US proves that interest rate normalisation can be sustained with ongoing economic growth. Growth may slow on a tough comparable period supported by fiscal expansion, but nonetheless, the combination of tight labour supply, improving wages and the promise of investment continues to place the US in a relatively strong position. As such, we have been happy to increase exposure to the US economy.

But rising wage growth and lower oil prices should support consumer spending and prevent growth from slipping below 'trend'. Given this, the Fed looks set to continue raising interest rates – though perhaps at a slower pace – in search of the elusive 'neutral' level.

The recent far larger than expected 312,000 increase in non-farm payrolls in December would seem to make a mockery of market fears of an impending US recession.

US – Nonfarm Payrolls (net monthly change (thousands) & Average Hourly Earnings YOY % change





Source: Macquarie

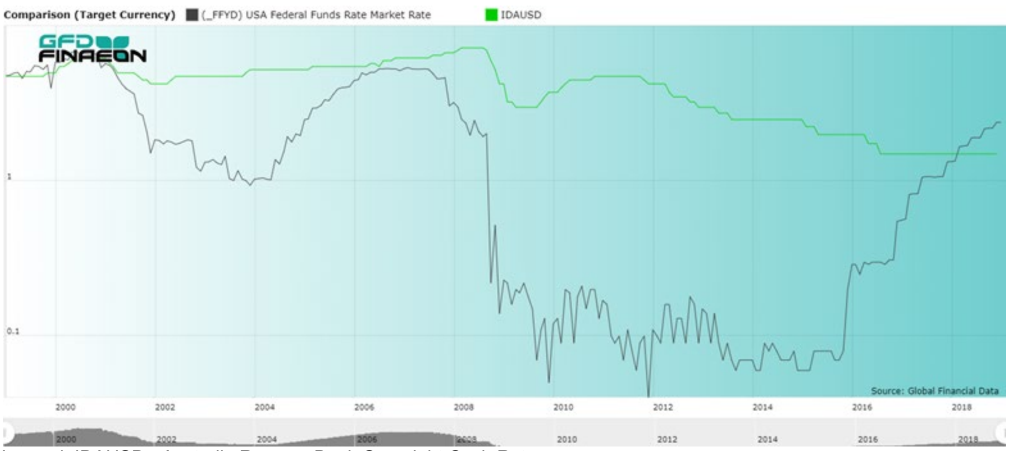
Admittedly, employment is a coincident indicator, whereas the ISM manufacturing index fell sharply in December, and is a leading indicator. But, even allowing for that distinction, the December employment report suggests the US economy is still expanding at an above-potential pace, which would normally require the Fed to raise interest rates.

AUD/USD FX rate

There has only been one other period in the last 20 years (from early-April 1999 to mid-April 2001) during and immediately following the Asian Financial Crisis when the Australian RBA OCR has yielded below the Fed funds (daily average yield differential = -20bps). Over the same period, the AUD/USD FX rate fell from 0.62 to 0.51 (i.e., -17%) despite a concurrent 10% increase in the RBA Commodity Price Index.

In March 2018, the Fed increased its target rate (mid-point) from 1.375% to 1.625%, above the RBA OCR for the first time since mid-April 2001. Since March last year, the Fed has continued to increase its target rate (mid-point) to 2.375% resulting in a current yield differential of -0.875% between the RBA OCR and the Fed funds rate, and we expect the Fed to increase by another 25bps-50bps over the next year.

US Fed Funds Rate Vs Australian RBA Overnight Cash Rate



Legend: IDAUSD - Australia Reserve Bank Overnight Cash Rate.

Since March 2018, the AUD/USD FX rate is down from 0.7761 to 0.6940 (i.e., -10.6%) in an environment where the RBA Commodity Price Index was largely unchanged (i.e., -1.8%).

In summary, we think the Fed is keen to get back into its neutral range of 2.5%-3.0%; therefore, they will increase the Fed funds rate by 25bps in CY2019 and then 25bps in CY2020 assuming the US avoids a cyclical recession. Based on an expected increasing negative yield differential over the next year or so (assuming the RBA doesn't increase the OCR), and negatively skewed China risks for commodity prices in the medium term, we see further downside risk to the AUD/USD FX rate in 2019. We also think there is a chance of a currency crash if China has another Minsky moment and Australia has a

house price crash (>35% fall) and a banking crisis over the next two years. JCP portfolios are positioned for a weaker AUD in 2019.

China's economic challenges

Escalating trade wars with the US

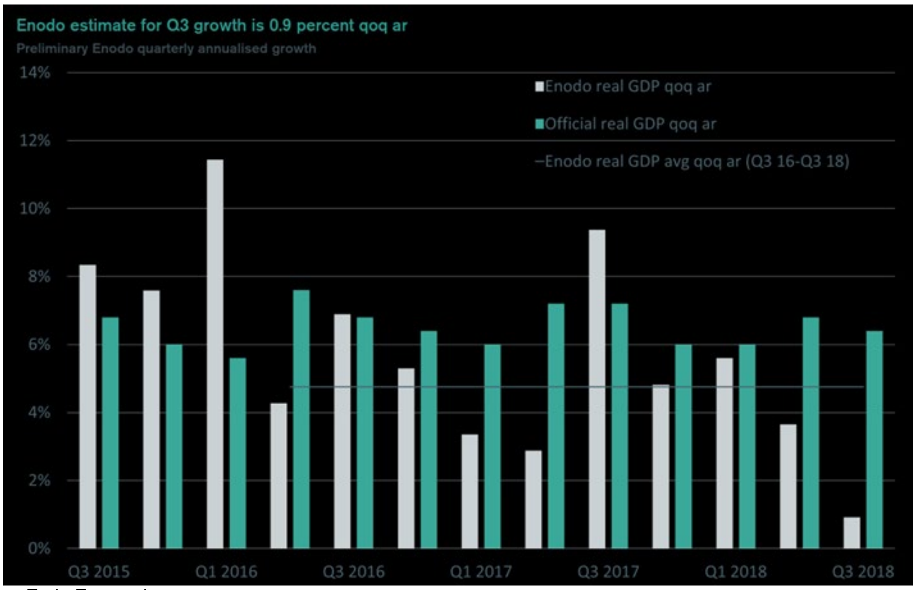
The US-China trade war is a tectonic shift in the global geopolitical order. The long-term implications will be far-reaching and may undermine the viability of China's economic model. If no deal on trade is agreed, the US is set to raise tariffs on US$200bn worth of Chinese imports from 10% to 25% by the end of February 2019. China has already made some concessions to reach a deal (e.g., opened previously closed sectors to foreign investment, lifted caps on joint venture investments, resumed purchases of American soybeans, announced tariff cuts on auto imports, and indicated that it will modify an industrial policy that stokes suspicion abroad). But there are some issues on which China will not yield to US demands (e.g., dismantling its system of industrial subsidies, and stop forcing foreign companies to transfer technology), making a comprehensive trade deal difficult to achieve.

If no trade deal is agreed, many economic commentators expect these, and other previously implemented tariffs will slow the Chinese economy by about 1% in 2019. Also, it will force China to shift policy in ways it would prefer not to; such as bringing its deleveraging campaign to an official close, cutting corporate taxes, running a bigger fiscal deficit, and softening its crackdown on shadow banks. Another source of discomfort will be the yuan. China has fought hard over the last couple of years to prop up its currency and curb capital outflows. As its trade surplus narrows, rather than easing capital controls (which is necessary if China is to make the yuan an international currency), China will instead need to reinforce them.

Weakening economic growth

The trade tensions are occurring in an environment where China's economic growth is deteriorating. Independent China Economist, Endo Economics suggest that Q3 was the weakest quarterly annualised growth rate since 2004 – even lower than during the global financial crisis.

China – GDP growth (Qtr)



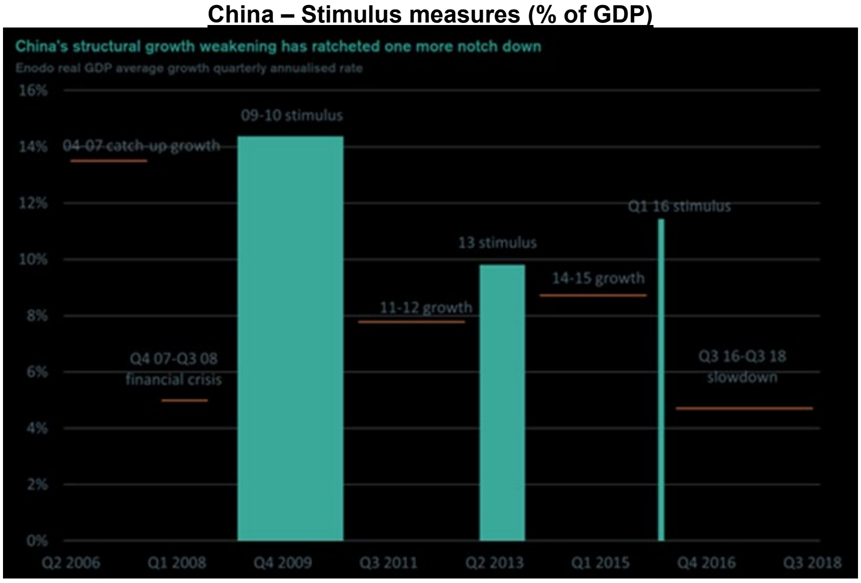
Source: Endo Economics

High-frequency consumer data are also weak, including retail volumes and car sales; and consumer sentiment leading to a higher propensity for them to save rather than spend.

Further Stimulus:

The risks to Chinese growth are on the downside. In these circumstances, to produce a significant positive surprise in the short term, Beijing would need to resort yet again to further stimulus; via a credit-driven investment boom and/or monetary stimulus. If they choose to go down this road, they could engineer a more vigorous recovery at the start of 2019, but will provide less stimulus than those in 2009/10, 2013, and Q1 2016 (see below chart). The PBoC announced on 4th January monetary policy stimulus measures, specifically an additional cut to the RRR by 1% in two separate steps of 50bps each on January 15th and 25th. The gross liquidity injection is equal to 1.5tn RMB or US$163b. The injection highlights that authorities have increased the urgency of supporting the economy.

China – Stimulus measures (% of GDP)

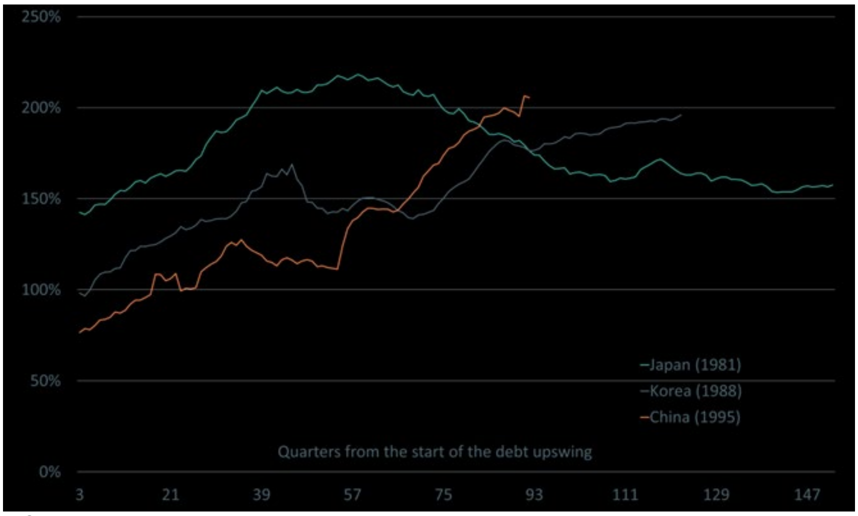


Source: Endo Economics

Debt reduction

The consequence of another period of stimulus would be a fast-rising debt-to-GDP ratio and a swift return of inflation. Beijing can just about afford to run those risks one more time. But the policy tightening and sharp growth slowdown that would inevitably follow would be much more painful than in the past, given how much the economy has already weakened. This scenario could well unfold before the end of 2019.

China – Debt to GDP (% of GDP)



Source: Endo Economics

Another Minsky moment in late 2019?

China experienced its last Minsky moment in 2015 when its FX rate dropped from just above USD/CNY 6 to nearly 7, and net capital outflows reached close to US$700bn (4-quarter sum). In late 2017, China's then retiring central bank governor, Zhou Xiaochuan, warned that China had been expanding far too quickly, resulting in excessive debt, asset price bubbles, and complex hidden risks that pose a major systemic danger to the Chinese economy.

Given China's weakening economic growth and a probable escalation of the trade war with the US, resulting in expectations of easing debt restrictions and another rapid build-up of Chinese debt; could China experience another Minsky moment in 2019? There are some early worrying signs: a material fall in the USD/CNY FX rate from 6.25 in late May 2018 to 6.88 at the end of December 2018 (-9%); a precipitous fall in the Shanghai SE Composite Index from 3558 in late January 2018 to 2494 in late December (-30%);

and a property market seemingly overheating with house price rises increasing from 4.7%pa in April 2018 to 9.3%pa in November 2018. Only time will tell, but the risk is rising.

In summary, China faces some shorter-term cyclical, and longer-term structural, economic challenges. The risks to Chinese growth are skewed to the downside. Therefore, Beijing will probably implement yet another credit-driven investment expansion. But this will generate less stimulus than those in 2009/10, 2013, and Q1 2016 and result in a fast-rising debt-to-GDP ratio and a return of inflation; which will be followed by policy tightening and sharp growth slowdown (later in 2019).

We expect the pollution crackdown to persist and continue to benefit materials inputs into lithium-ion batteries (lithium and graphite) as China looks to electrify their car fleet; and also increasing the use of LNG for generating electricity. We continue to believe that over the medium term, slowing Chinese credit growth and structural reforms may negatively impact Australian real estate, investment, and exports; which will will be negatively exacerbated if China has another Minsky moment in the next 18 months.

Portfolio Positioning

JCP portfolios comprise stocks that that reflect the following broad thematics:

- Long global growth
- Long volume beneficiaries from Australian population growth
- Long electric vehicle battery raw materials
- Long energy (oil & gas)
- Long gold
- Underweight Australian banks
- Underweight REITs

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