Jamieson Coote Bonds

CIO Insights - August 2018

- More 'out-of-cycle' rate rises from domestic banks
- Emerging markets, emerging risks?
- Global capital expenditure downturn
- Recent currency weakness boosting individual economies
- Be selective with your fixed income

JCB Performance Since Inception*

PERFORMANCE*	GROSS RETURN	NET RETURN	INDEX	vs INDEX NET FEES
1 MONTH	0.89%	0.82%	0.94%	-0.12%
3 MONTHS	1.63%	1.44%	1.58%	-0.14%
12 MONTHS	4.05%	3.32%	4.01%	-0.69%
24 MONTHS	1.93%	1.19%	0.99%	0.20%
36 MONTHS	3.74%	3.02%	2.91%	0.11%
SINCE INCEPTION ANNUALISED	4.21%	3.48%	3.12%	0.36%

* Inception date of the unit trust is 1/12/2014. Inception date vs index is 31/12/2014. Past performance is not an indicator of future performance.
** Net Asset Values (NAV) are quoted after the deduction of all fees and expenses. JCB Active Fund aims to pay distributions semi-annually at 2% p.a. of NAV: a distribution of 1.0% was paid on 30/06/2018.

DATE	NET ASSET VALUE	ENTRY PRICE	EXIT PRICE	AVERAGE RATING
31st AUGUST 2018**	1.0631	1.0642	1.0620	AAA

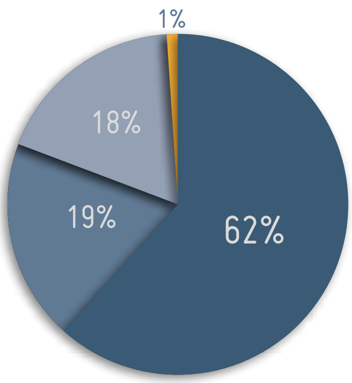
Jamieson Coote Bonds Active Fund (JCBAF) - August 2018

Month End Portfolio Mix

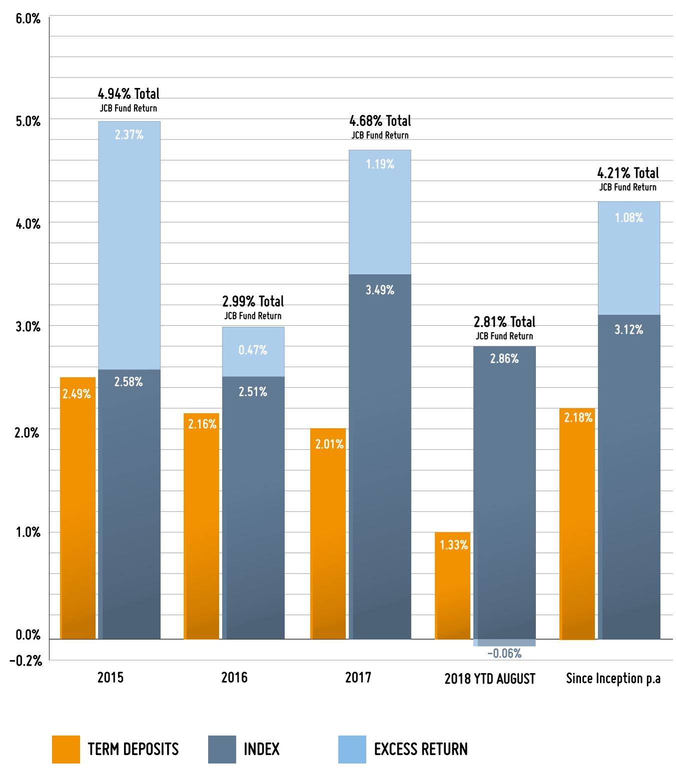
Australian Government Bonds	61.7%
State Government Bonds	19.1%
Supra National Bonds	18.2%
Cash	1.1%

KPI Averages

Duration	4.65 years
Index Duration	6.17
Average Coupon Rate	3.52%
Tracking Error	0.71
Average Weighting	AAA



JCB Calendar Year Gross Returns vs Term Deposits



Source: Reserve Bank of Australia (as at August 2018) and Channel Capital (as at August 2018 as the fund's administrator). Assumes retail deposit & investment rates for amounts over A$10000 held for six months. Aus Govt Bond Index: Bloomberg Ausbond Treasury 0+ yr index and Excess Return is the return generated by the JCB Active Bond Fund (institutional, inception: 1 Dec 2014) over the index. Past performance is not an indicator of future performance.

JCB

Jamieson Coote Bonds

More 'out-of-cycle' rate rises from domestic banks; market overreacts to logical consequence of higher cost of global capital

The Australian Bond market rallied after Westpac announced a 14 basis point (0.14%) mortgage rate rise to offset the increased cost of funding. Such a move further curtails any perceived need for the RBA to lift official interest rates. Financial conditions are tightening in the banking system as a function of rising funding costs for consumers (i.e. via higher floating mortgage rates and higher fixed rate rollovers). It looks almost certain that this trajectory will continue as the U.S. Federal Reserve (the Fed) continues to raise the international cost of capital. The market reaction to the Westpac hike (others banks will likely follow) has been a powerful rally in isolation from global fixed income. JCB sees this as an opportunity to lighten our risk exposures at the highest valuations of the year, consistent with our active approach to navigating these dynamics.

Emerging markets, emerging risks?

Emerging markets have generally been risky, aside for the last decade where excess global liquidity from Quantitative Easing (QE) papered over the many cracks in the volatile landscape and allowed for low market volatility to lure investors (under the assumption that these markets are low risk and provide excess return). The removal of such liquidity is now reverting these countries to their longer term trend characteristics. JCB cautions investors to tread carefully in emerging markets as capital can be lost very quickly – particularly in crises periods. Emerging market stresses tend to occur when global data and inflation cycles peak, combined with U.S. denominated debt rapidly increasing. Excess borrowing (via what was originally an inexpensive USD) provides high leverage and, as the USD rises due to Fed rate hikes, debt repayments become increasingly difficult. JCB notes all of these conditions are observable today. Ironically, emerging markets are a fast forward view of domestic credit markets under higher rates and debt delinquency.

Turkey and Argentina are possible candidates for an emerging market rout in this cycle, requiring International Monetary Fund (IMF) restructuring to alleviate macroeconomic, foreign exchange, debt and inflation problems that are now too substantial to survive alone. Contagion looks possible into Indonesia, South Africa, India and Pakistan.

Until the IMF or capital controls are announced, emerging markets and all growth assets should remain weak. The damage to global growth via falling commodity prices and mining stocks, alongside an inflation cycle peak, are signs that growth is being reassessed as the unintended consequences of the Fed hiking cycle.

Global capital expenditure (capex) downturn

Australian estimated capital expenditure (capex) disappointed for the month of August, posting negative 2.5%, reflecting decreased business confidence. JCB expects that this will be a global issue in a world threatened by increased tariffs. It is rational that boardrooms the world over will place capex intentions on hold until tariff levies are announced and the associated costs of each jurisdiction can be better quantified.

Recent currency weakness boosting individual economies

JCB believes that we are in a late cycle environment of U.S. and USD asset outperformance, but within that long cycle investors will still experience peaks and troughs. The global economy could be on the cusp of a mild cyclical recovery led by weakness in USD (U.S. economy has peaked relative to all others). Such a USD move would be counter trend in what JCB still believe is a major period of USD outperformance. However, with China down 20%, emerging markets down 20%, commodities experiencing similar drawdowns (e.g. copper -18%), many markets have moved significantly in relation to USD assets. Positions have swung from short USD (long EUR, AUD, commodities, gold, etc) back in September 2017 to March 2018 when the DXY (the U.S. dollar currency index) was 88, to now being long DXY, a seemingly extreme divergence in a relative market context. Markets have moved from one side of the ship to the other with expectations and positioning now set up for USD asset outperformance. However, JCB believe this has already occurred.

JAMIESON COOTE BONDS

JCB expects other countries to outperform low expectations for a short period as recent currency weakness and suppressed domestic bond yields help boost individual economies on a relative basis. This should also coincide with a short period of U.S. underperformance relative to its high market expectations. Data velocity has turned negative for the U.S. whilst broadly positive for the rest of the world excluding emerging market economies. Concern remains in pockets of major economies with Brexit still up in the air and Italian politics likely to continue to dominate noisy headlines.

Be selective with your fixed income

JCB learned in August 2018 of a significant unconstrained 'go-anywhere' bond fund having to freeze its underlying assets and impacting circa A$5 billion in Australian-sourced investments. To underline our comments from last month, JCB are disappointed with this less than positive outcome for investors. This story endures as the situation has now moved into liquidation phase with all fund investors to receive their proportionate interest in cash from the liquidation process. The first payment due is in early September and investors who participated via the Australian and Cayman funds will receive between 60 and 66 per cent of assets. This leaves up to 40 per cent still restricted. If the remaining assets cannot be 'liquidated' what does that say about the asset quality?

This specific case remains a cautionary tale in terms of understanding the underlying instrument and strategy, complexity versus simplicity, opaqueness versus transparency – hard lessons learned post the GFC.

CC JCB Active Bond Fund returns in August

For the month of August, the CC JCB Active Bond Fund (the Fund) returned 0.82%, underperforming the Bloomberg AusBond Treasury (0+Yr) Index by 0.11%.

JCB maintains a structural overweight exposure to the AUD long-end holdings, a 10 year versus 30 year flattening exposure which remains cheap in a global context. This underperformed over the month in expectation of new issuance from the Australian Office of Financial Management of a new 2050 inflation linked security. JCB will use any further cheapening to materially add to this exposure.

JCB also took profits on duration into what they believe is an overreaction by the market to the Westpac rate hikes. With bond supply globally due to lift in September, JCB feel better levels will be available to re-establish additional duration positions.