JCB

JAMIESON COOTE BONDS

- 3.00% US 10 year yields, over hyped but a natural target
- Banking Royal Commission wash up to see credit conditions tighten further, dragging on second half growth
- One by one, RBA rate hike calls are removed
- $AUD dives below 75 cents as inflation stays below RBA target
- The oldest story in finance

JCB Performance Since Inception*

PERFORMANCE*	GROSS RETURN	NET RETURN	INDEX	vs INDEX NET FEES
1 MONTH	-0.46%	-0.52%	-0.56%	0.04%
3 MONTHS	0.73%	0.55%	0.89%	-0.34%
6 MONTHS	1.04%	0.68%	0.80%	-0.13%
12 MONTHS	2.33%	1.63%	1.85%	-0.22%
24 MONTHS	2.68%	1.94%	1.99%	-0.05%
36 MONTHS	3.59%	3.06%	2.36%	0.51%
SINCE INCEPTION ANNUALISED	3.92%	3.20%	2.71%	0.49%

* 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 31/12/2017

DATE	NET ASSET VALUE	ENTRY PRICE	EXIT PRICE	AVERAGE RATING
30TH APRIL 2018**	1.0516	1.0527	1.0505	AAA

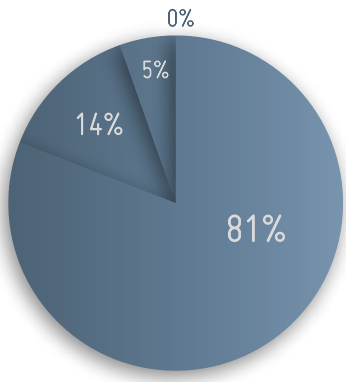
Jamieson Coote Bonds Active Fund (JCBAF) - April 2018

Month End Portfolio Mix

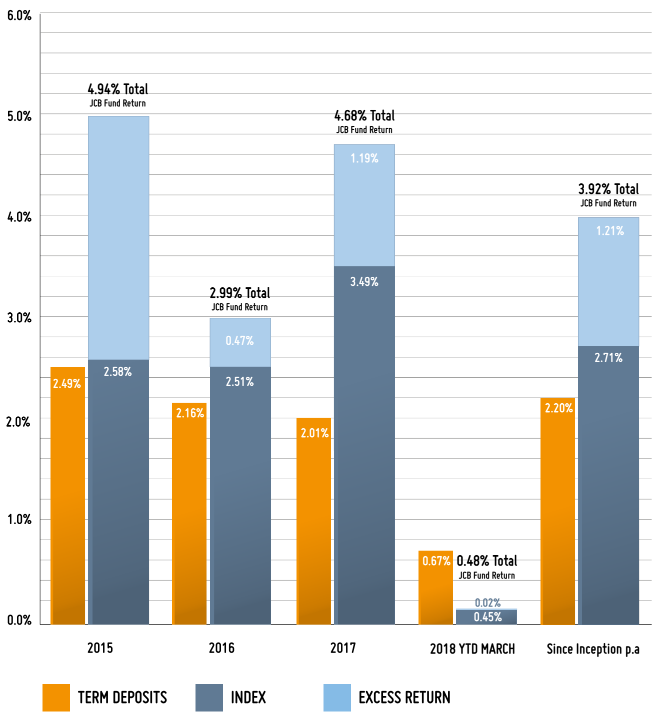
Australian Government Bonds	80.9%
State Government Bonds	13.7%
Supra National Bonds	5.1%
Cash	0.3%

KPI Averages

Duration	5.49 years
Index Duration	6.11
Average Coupon Rate	3.92%
Tracking Error	0.54
Aveerage Weighting	AAA



JCB Calendar Year Gross Returns vs Term Deposits



Source: Reserve Bank of Australia (as at April 2018) and Channel Capital (as at April 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.

3.00% U.S. 10 year yields, over hyped but a natural target

The old adage, “when the U.S. sneezes, global markets catch a cold” speaks volumes about the size and influence of the U.S. markets relative to the rest of the world. In bond space, much attention is accordingly paid to where U.S. 10 year Government Bond yields are tracking: this marker has profound influence across the financial world on the cost of borrowing, the accessibility of credit and ultimately economic activity.

During April 2018, U.S. 10 year Government Bond levels breached 3.0% off the back of perceived inflationary pressures and a hawkish Federal Reserve which has recently backed U.S. economic growth healthy enough to withstand higher rates. This coincided with geopolitical headlines and ongoing U.S., Chinese, Russian and Iranian dialogue which heightened financial market volatility. Selected popular media segments zeroed in on the bond move – according to them – it could portend further selling of Government Bonds worldwide. JCB does not believe that such expectations are warranted given a global economy that is already slowing quickly as funding pressures rise (see March monthly comments on data velocity). JCB simply view these outcomes as part of a normal functioning of markets within a broader hiking cycle.

The rise in U.S. yields has naturally brought many other global markets along for the ride. In Australia, for instance, interest rates across the yield curve also rose in sympathy despite the domestic economic fundamentals not justifying such a change. Meanwhile, it is helpful to remember the broader context: rises in 10 year rates drive borrowing costs across the system. Material and sustained moves would potentially harm the real economy by stifling activity, and ultimately bleed through to other assets such as shares and property.

This bond market re-pricing has continued to encourage reflection and alteration amongst domestic investors on the right-sizing of their defensive asset allocations. In what is universally recognized as a quite late-cycle stage, sophisticated investors (such as institutions including large superannuation plans and industry funds) have latched onto the theme that interest rate risk and credit risk will likely diverge moving forward. This sentiment makes sense against concerning breadcrumb indicators of weakening credit conditions which are now routinely emerging. For example, Bloomberg shone light on the rising stress amongst companies in the recent survey by the National Association of Credit Management. A highly competitive and seemingly strong economy has forced firms to boost borrowing at low rates to keep pace with competitors. However, the survey results revealed the difficulty in remaining on top of debt as illustrated by creditors’ ability to collect money owed by their customers – this tumbled to 46.7 in April from 59.6 in March, putting it at its lowest level since early 2009, the height of the financial crisis.

Banking Royal Commission wash up to see credit conditions tighten further, dragging on second half growth

The Hayne Banking Royal Commission has captured widespread attention and has uncovered a number of disturbing behaviors and decisions reeking of greed and downright fraud. Liar loans, cash bonuses for processing fraudulent loans with incentive bonuses for writing additional loan business, shameful and willing deceptions of the financially vulnerable. Changes will occur in coming periods through increased regulation and oversight, as well as perhaps criminal penalties for executives. From an economic viewpoint, the depressing lessons will have a deep impact on the lending process in the form of higher hurdles to approve loans, greater scrutiny of prospects and less emphasis on pure sales (i.e. balancing shareholder with client needs). The net result is likely heightened pressure on credit standards and, ultimately, borrowings with effects on lending activity in Australia. The timing economically is not ideal given that conditions have already been tightening in view of global funding rates have been trending upwards (led by the U.S. Federal Reserve). And the domestic Australian outlook is already looking challenged by a deeply indebted Australian household which is facing the prospect of softer or falling property 2018+ prices. Where formerly bricks and mortar have steadily been appreciating and therefore represented a key driver of consumption, this condition is likely to lessen, applying additional pressures on households.

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Jamieson Coote Bonds

One by one, RBA rate hike calls are removed. Holdings strategists' feet to the fire

Conventional public relations wisdom tells us that controversial headlines are more likely garner attention in the media than not. Thus, for those bond market professionals motivated to secure air time, an easy way to become front-and-centre is to call for RBA rate rises against a fragile and uneven environment (as we currently find ourselves). Since late 2017 and early 2018, a number of strategists have called for such moves with little regard for the broader economic picture. Many of these market calls from domestic banks, macro funds and other finance firms have tended to evaporate as more information released underlines the soft economic ground we find ourselves on.

JCB's view, in contrast, has tended to be non-sensationalist: a higher (and growing) cost of global capital would suppress consumers at a time when Australian households are highly interest rate sensitive and enjoy little wages growth to offset such a cost push. Whilst we have been vocal in our view of 'RBA on hold' for some time, we are not entirely wedded to that view and will gladly call for rate hikes when we feel they are truly imminent. The major change that could allow for RBA rate hikes would be AUD currency depreciation.

$AUD dives below 75 cents as inflation stays below RBA target

Ironically, Australia's continued weak inflation pulse generates its own inflation via currency depreciation. Soft inflation kills any future RBA hiking expectation which removes heat out of the currency due to lower expected interest rates (domestic rates versus the U.S. interest rates). JCB has written previously on the power of interest rate differentials driving foreign currency valuations in the longer term. As short dated U.S. interest rates continue to rise, JCB felt this year the USD would benefit (see JCB December 2017 monthly "2018 the year of the USD") and AUD currency weakness would prevail. Such weakness opens up possible year-end targets towards 68 cents, which would help generate the missing inflationary impulse in the Australian economy via a rise in tradeables inflation. Whilst currency movements in the short term are often 'random walk', interest rate differentials have excellent long run predictive abilities and JCB retains the view that the USD should continue to appreciate. A lower AUD is potentially good news for the RBA, however, investors must remember that the RBA are focused on the value of the 'trade weighted' AUD, rather than the USD cross rate alone. From the highs earlier this year the trade weighted AUD has declined around 5.5%, helped no doubt by the Royal Commission findings.

The oldest story in finance

The U.S. Federal Reserve is projecting six more rate hikes by the end of 2019. This is known and priced in by markets. However, JCB is not alone in worrying that this is potentially a repeat of the oldest story in finance – too many hikes will invert the term structure interest rate curve (short rates will be higher than longer dated rates) and this will trigger a recession. No doubt the U.S. Federal Reserve will alter their thinking as risk markets decay but, so far, they have shown no interest in backing down. It is important to emphasize that none of this is imminent. The U.S. economy is not yet at risk and the share market would have to undergo a larger correction before the Fed might begin to back off its lofty expectations for hikes. That said, the markets have seen this story before. If the economy slows or the share market collapses, the Fed will be forced to change. Otherwise, the Fed will continue to push their current agenda and risk markets will grow increasingly uncomfortable.

JCB portfolio performance in April

JCB portfolios outperformed indexes in April during a volatile month for shares and bonds. Intra month the U.S. bond market breached the psychological 3.0% 10 year yield area before receding. JCB lifted portfolio durations to be +0.7 years overweight the Bloomberg AusBond Treasury Bond Index intra month given the improved valuations and greater opportunity set. We exited this overweight position into the month end rally, bringing the portfolio back to be 0.6 years underweight.

JCB continues to hold a bias to front end yields to opportunistically anchor the portfolio. This position has modestly dragged on performance, however, we continue to believe this is the best risk/reward for absolute returns. Our investment belief and approach means we will take time to monetise these positions and, as such, we look to add to these positions on any back-up in yields. Whilst we continue to see value in current market pricing across all maturities, we believe rates will be range bound around current levels for now. This provides ongoing active management opportunities, before rallying into the European and North American summer period.