Auscap Asset Management

Auscap Long Short Australian Equities Fund

Newsletter – October 2019

Fund Performance*

Period	Auscap	All Ords
September 2019	2.2%	2.1%
Financial Year To Date	3.8%	2.8%
Since Inception	181.6%	100.9%
Annualised Returns	16.4%	10.8%

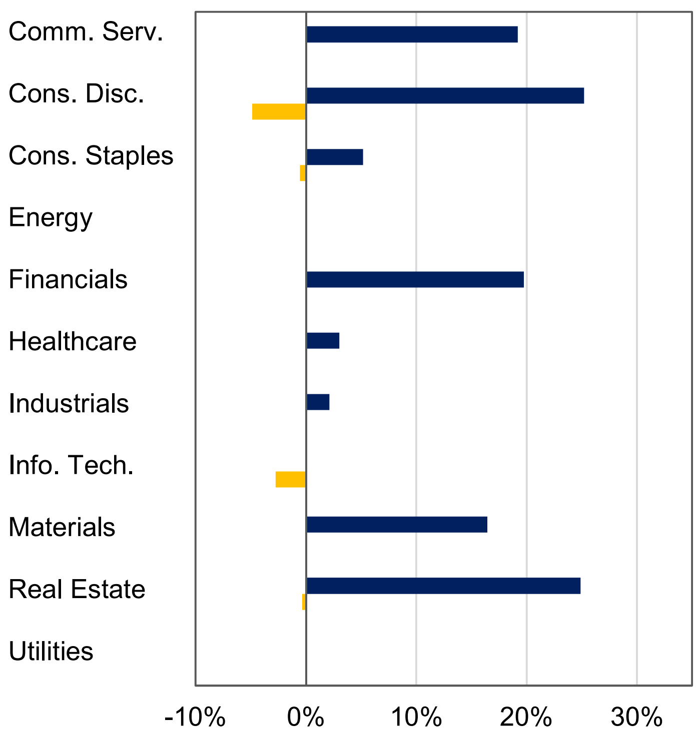
Fund Exposures

September 2019 Average	% NAV	Positions
Gross Long	115.9%	28
Gross Short	8.5%	7
Gross Total	124.4%	35
Net / Beta Adjusted Net	107.4%	95.1%

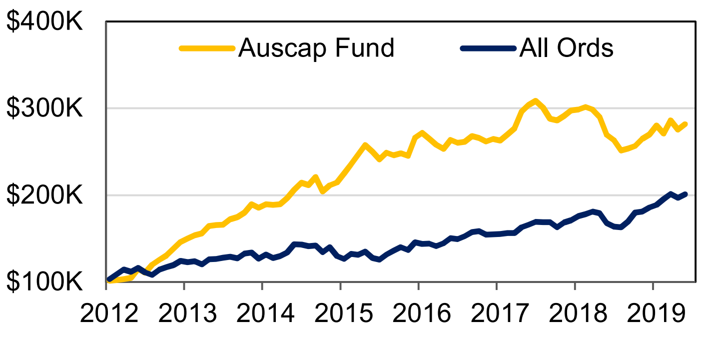
Portfolio Commentary

The Fund returned 2.2% net of fees during September 2019. This compares with the All Ordinaries Accumulation Index return of 2.1%. Average gross capital employed by the Fund was 115.9% long and 8.5% short. Average net exposure over the month was 107.4%. Over the month the Fund had on average 28 long positions and 7 short positions. The Fund's biggest stock exposures at month end were spread across the real estate, consumer, financials, communication services and materials sectors.

Sector Exposure - September 2019



Fund Performance*



Fund Financial Year Returns*

FY13	19.7%	FY18	12.7%
FY14	46.0%	FY19	(9.2%)
FY15	16.8%	FY20 (YTD)	3.8%
FY16	20.1%	CY19	12.0%
FY17	8.0%		

Top 10 Investments^

Blackmores	Mineral Resources
CYBG	National Australia Bank
GDI Property Group	Nine Entertainment
JB Hi-Fi	Super Retail Group
Macquarie Group	Unibail-Rodamco-Westfield

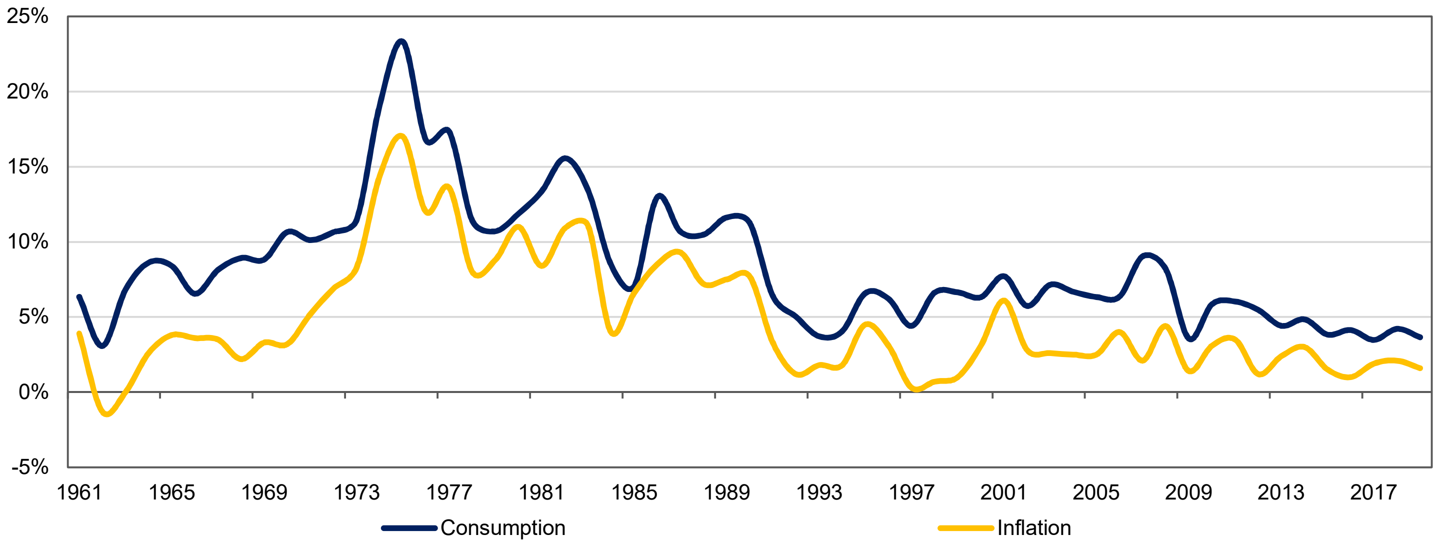
** Performance figures are calculated for the lead series net of all fees and expenses assuming the reinvestment of all distributions. Past performance is not a reliable indicator of future performance.*
^ Top 10 long investments in alphabetical order as at 30 September 2019.

Indicators For Optimism In The Australian Economy

Being objective and rational in the face of consensus bullishness or bearishness is one of the most challenging aspects of investing. The human response to information tends to be quite similar, and we all receive much the same information. We are all reading the same news and exposed to largely homogeneous commentary. As a result the market ebbs and flows between extremes in sentiment far more than is warranted by changes in the underlying economic data. This is where the emotional reflex exaggerates the effect of information that is incrementally positive or negative. Recently there has been an abundance of bearish commentary. In various pockets of the world we have trade wars, Brexit, political instability, social unrest, a technology bubble and climate change issues to work through (to name but a few). Domestically the Reserve Bank of Australia (RBA) has been lowering the cash rate and the discussion has turned to quantitative easing. Many are asking whether this portends bad times ahead. Is Australia finally due a recession? While the future is unknowable, and undoubtedly a domestic recession will occur at some point, there are presently reasons to be optimistic about the outlook for the Australian economy. In this newsletter we outline a few.

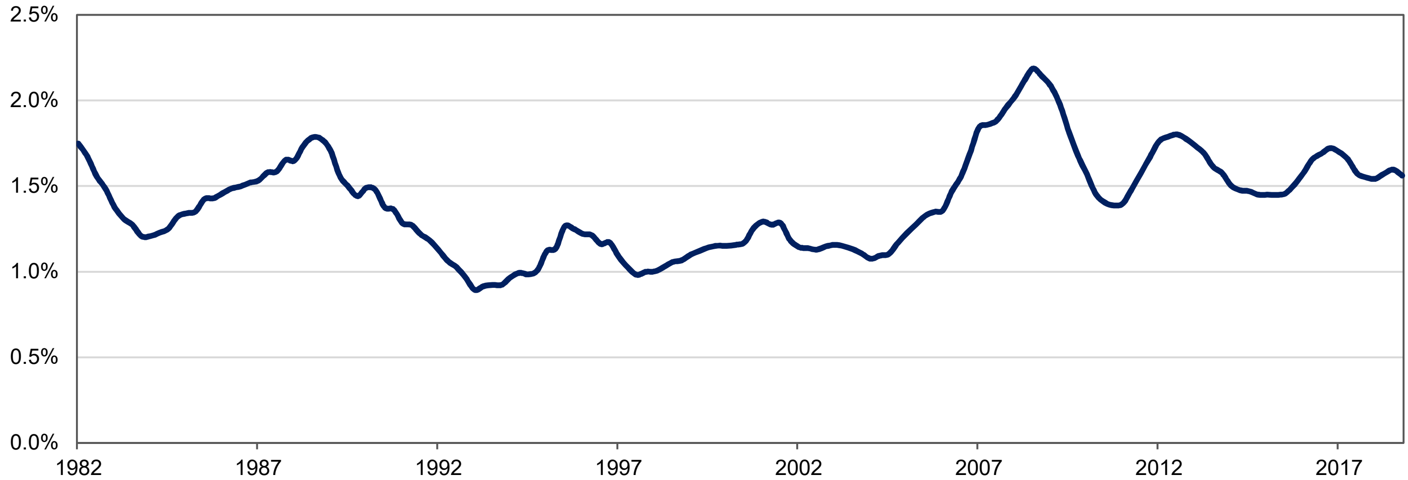
Consumption is the largest part of the economy, accounting for circa 57% of Gross Domestic Product (GDP) in FY19. While growth in consumption is weaker than it has been in past decades, this is in large part due to lower inflation. Growth in consumption remains a solid driver of Australia's economic growth, as it has been in the past.

Growth in consumption YoY (%)



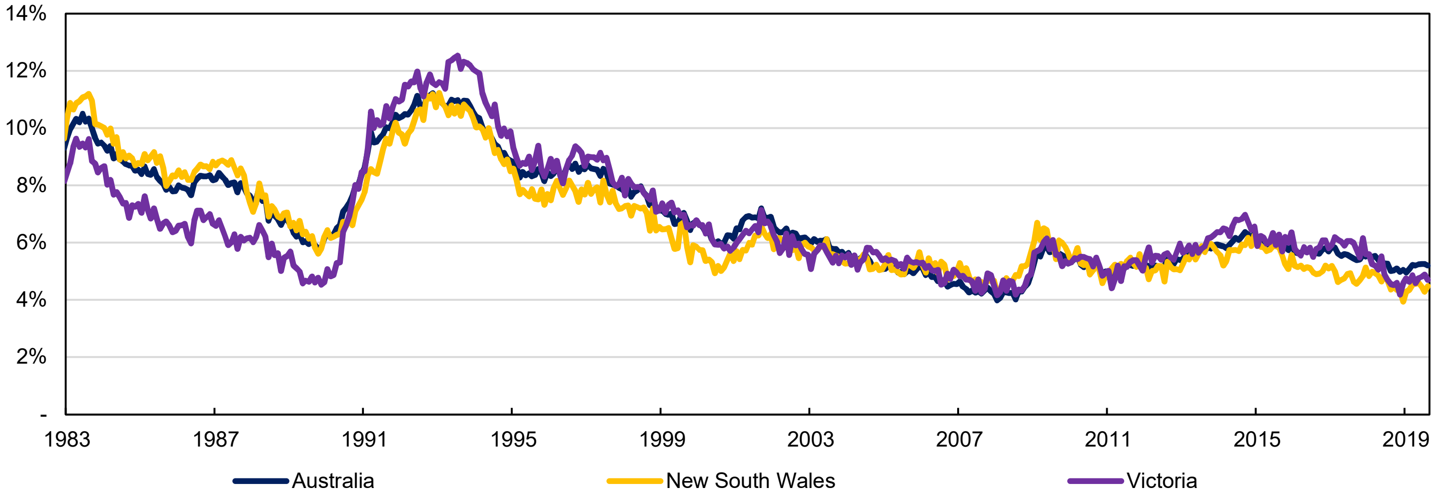
Growing consumption is in part driven by strong population growth, resulting from healthy natural growth and net migration.

Australian population growth (%)



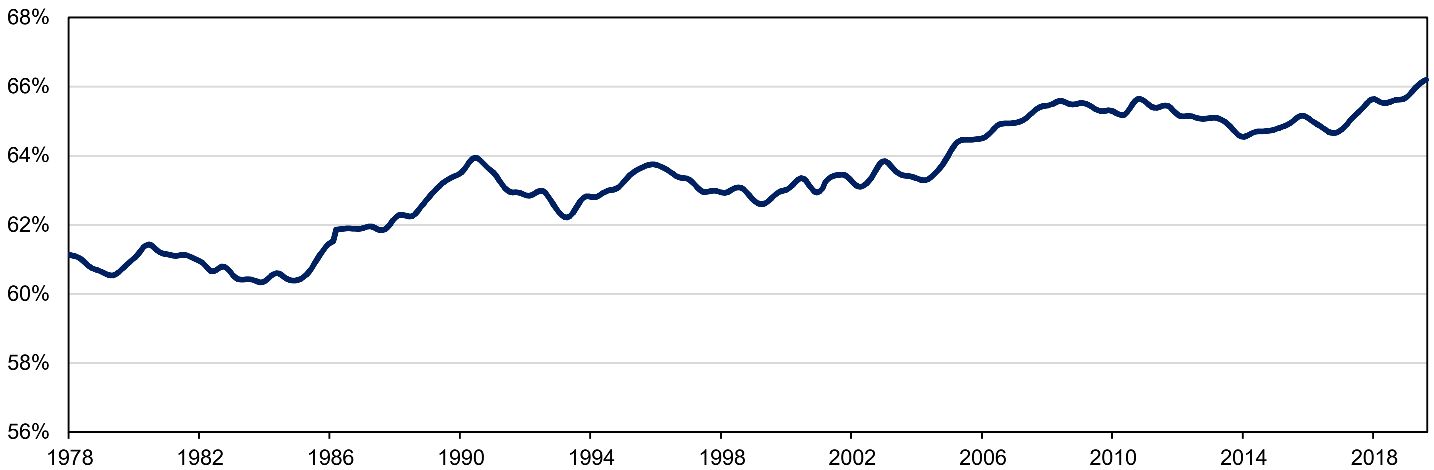
Unemployment also impacts disposable income and hence consumption. While the RBA has recently stated that it is targeting a lower unemployment rate, in historical terms the Australian unemployment rate is low. The unemployment rate in Australia's two most populous states, News South Wales and Victoria, is even lower than the national average.

Unemployment rate (%)



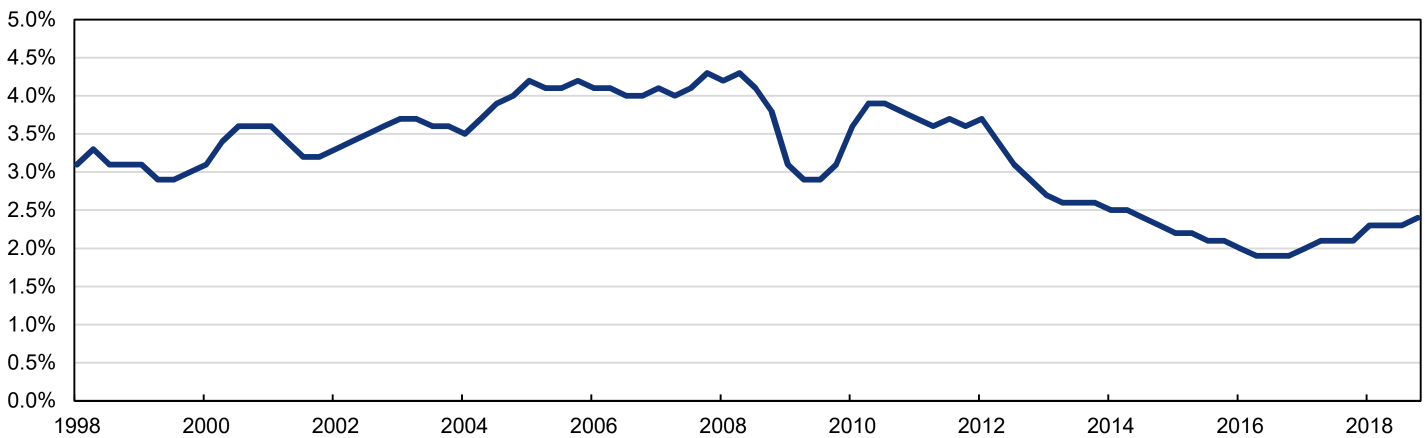
This is encouraging given the fact that the national participation rate is now the highest on record.

Australian participation rate (%)



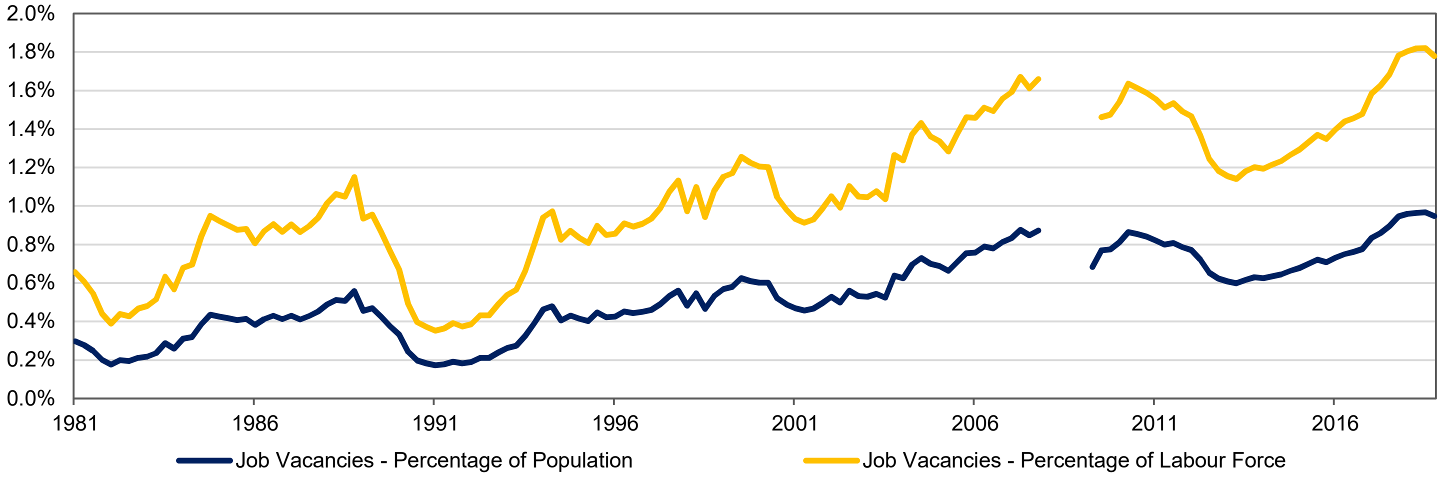
Wage growth has been improving in recent years.

Wage growth



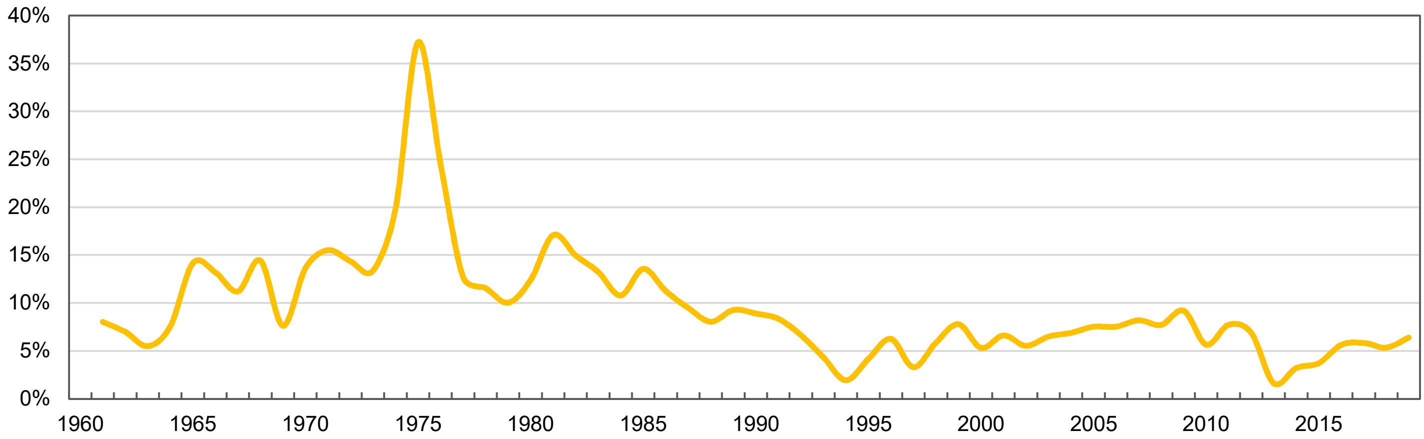
Job vacancies, while softening recently, remain elevated as a percentage of both the population and labour force.

Australian job vacancies



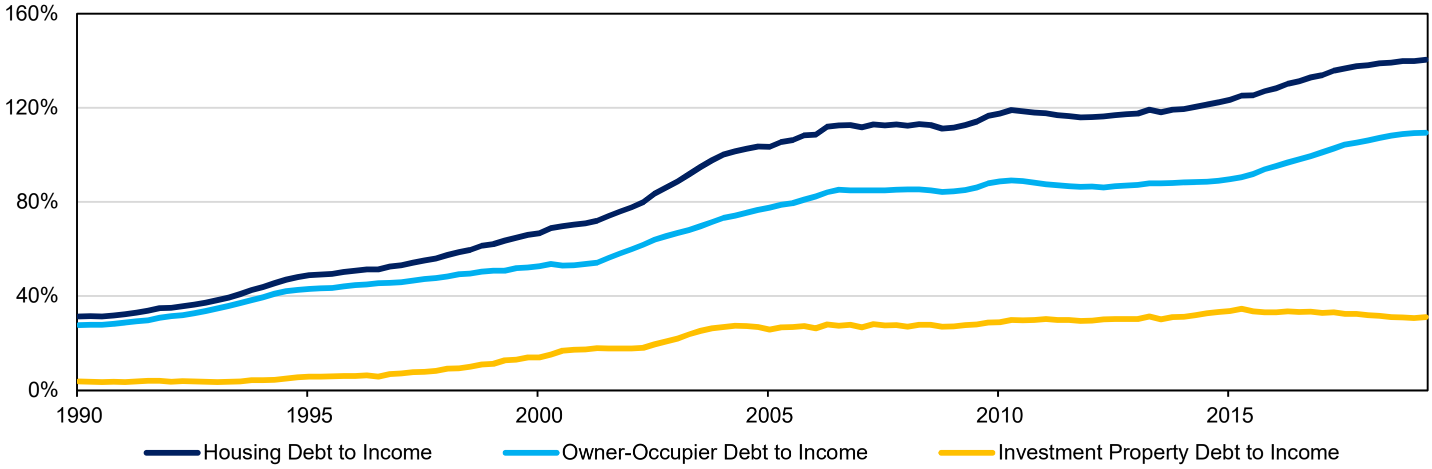
The Federal Government's forecast return to surplus in FY20 has resulted in tax cuts that became effective on 1 July 2019, and should see a continuation of the solid growth in Government expenditure, which is already growing at a healthy rate.

Growth in government spending (YoY)



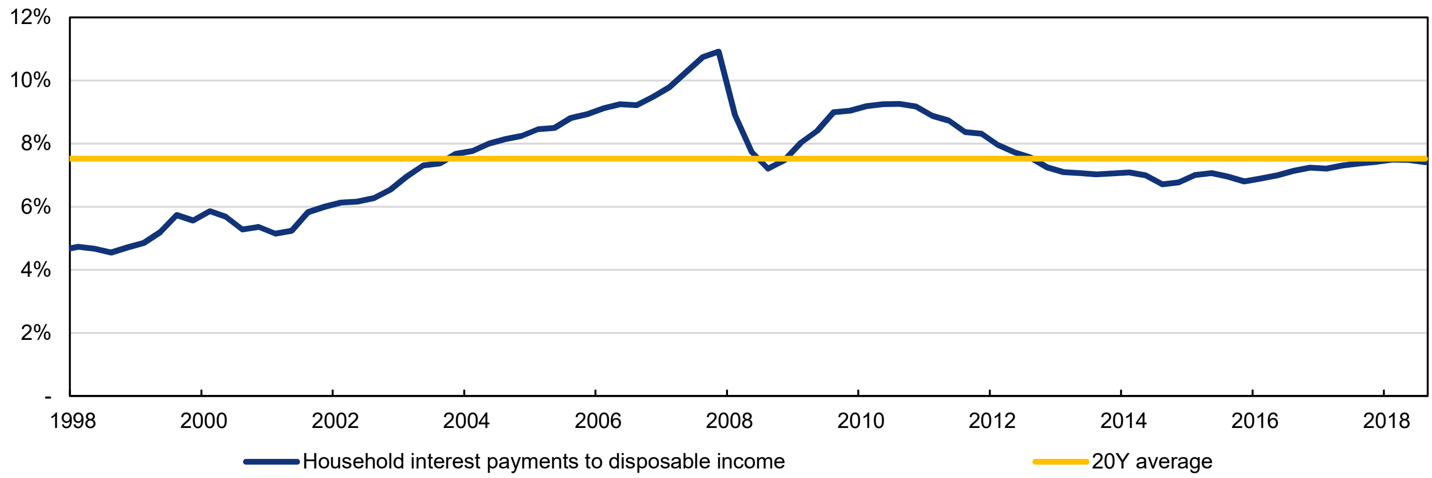
It is certainly worth acknowledging that household debt levels are elevated, leaving households vulnerable to a significant increase in interest rates.

Housing debt as % of household disposable income



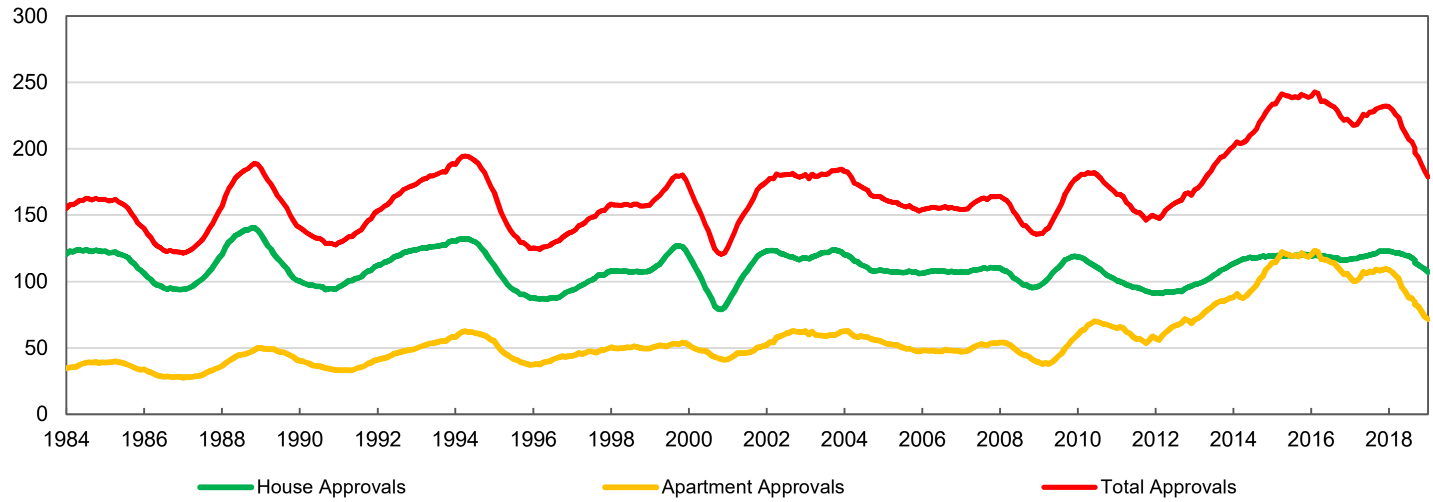
However interest rates have been falling and interest payments as a percentage of disposable income appear manageable given they are below the 20 year average. This data pre-dates the recent RBA rate cuts which should lower the ratio further.

Household interest payments to disposable income (%)



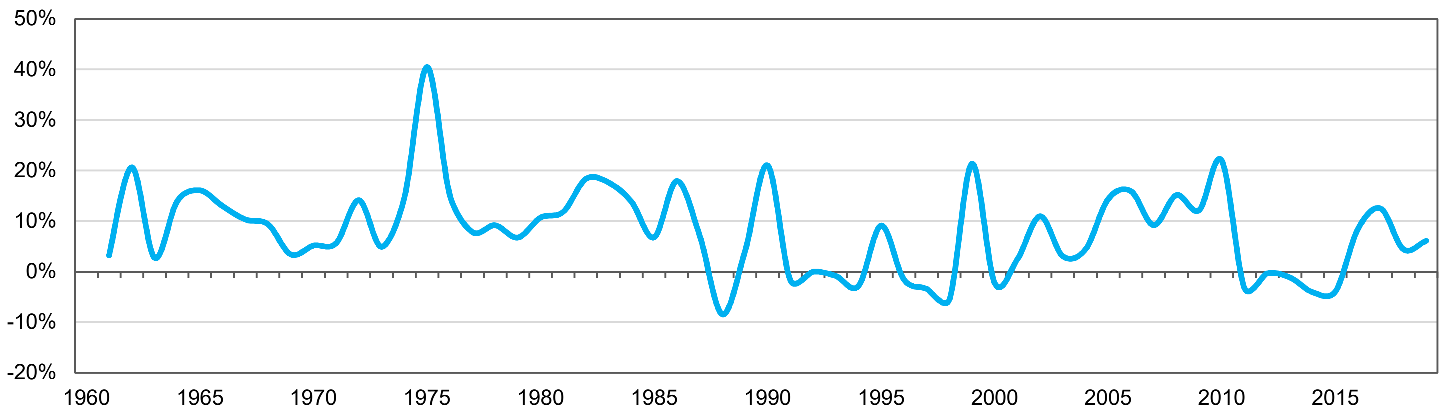
The decline in building approvals is likely to result in residential construction experiencing a slowdown in 2020. This will act as a drag on domestic investment. However national vacancy rates are low, which should result in a rebound thereafter.

Australian building approvals ('000)



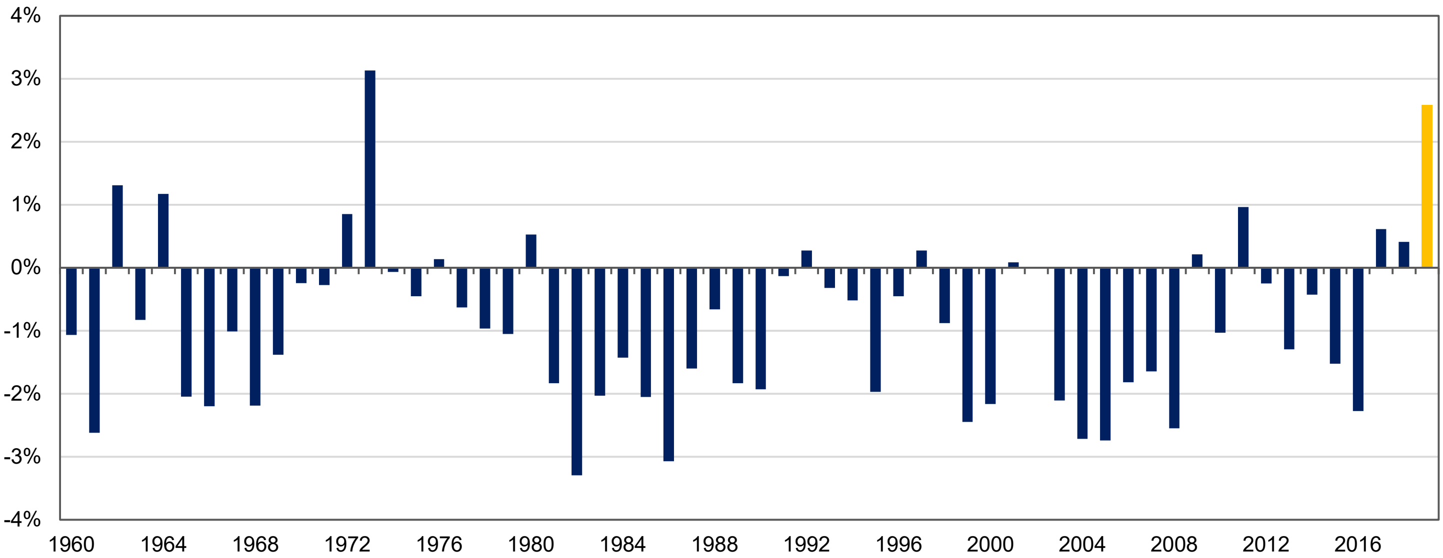
And growth in public investment should continue to accelerate given the promises made by the successful parties in the Victorian, New South Wales and Federal elections, on top of what was already a significant future pipeline.

Growth in public investment YoY (%)



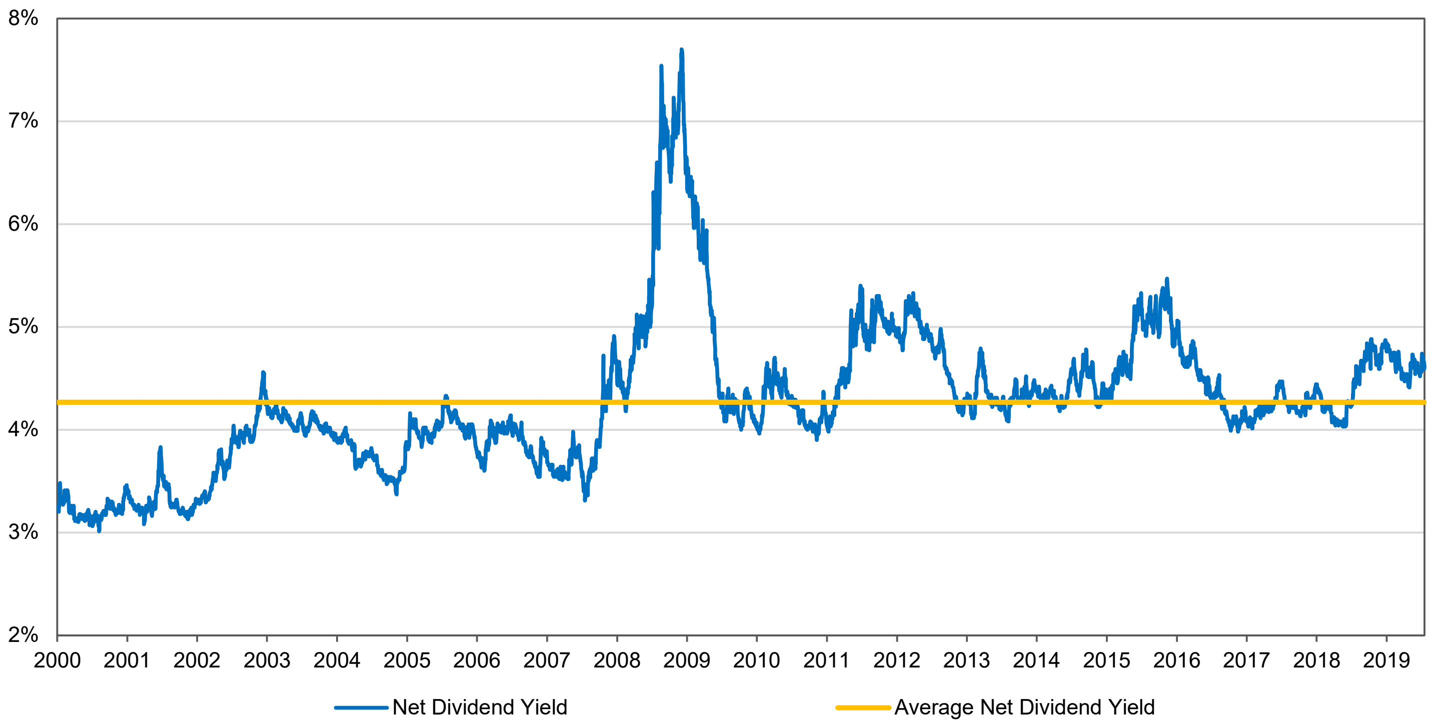
Further, there have been major infrastructure commitments from BHP Group, Rio Tinto, Fortescue Metals Group and Woodside Petroleum that should start to contribute to growth from the final quarter of 2019 or early 2020. The strength of our resources sector has been evident in our terms of trade. In FY19 Australia produced a $50bn terms of trade surplus. Historically Australia has typically run a terms of trade deficit. This surplus was the second largest as a percentage of GDP in the last 50 years. On the assumption that demand remains strong in the years ahead, this strength could continue and provide a natural tailwind to the domestic economy.

Net exports as a percentage of GDP



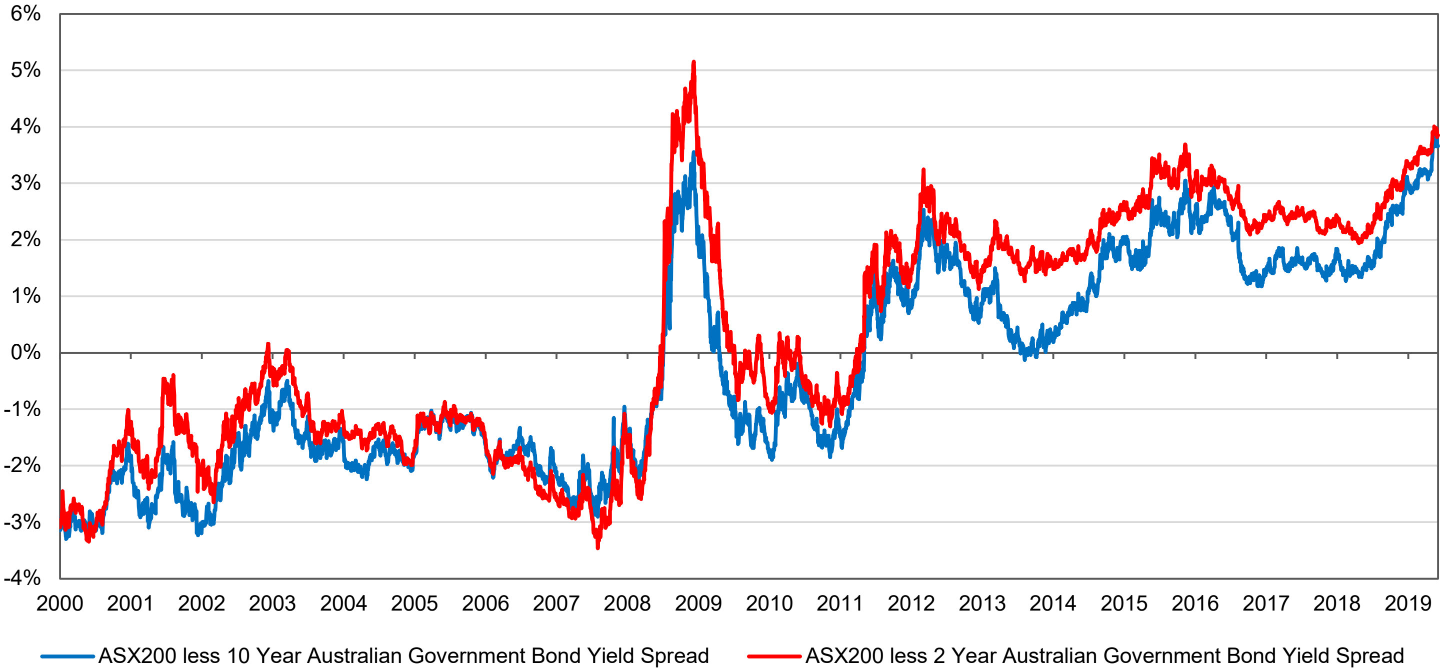
Our conclusion is that there continues to be plenty of reasons to be optimistic about the outlook for the Australian economy. As former Federal Treasurer Peter Costello remarked at a Citi investment conference recently, *"the objective conditions are not booming but they are not recessionary either"*. This sentiment does not appear to be aggressively factored into the price of shares. Despite record low interest rates, which is supportive of growth, the dividend yield on the ASX200 is above its long term average.

ASX200 Dividend Yield



Further, the implied equity risk premium, if measured as the difference between the yield on equities and the yield on Australian Government bonds, is extremely elevated, suggesting significant relative value in equities over bonds.

ASX200 yield spread to Australian Government bonds



Australia continues to have all of the hallmarks of an economy that should continue to see good long term through-the-cycle growth and prove to be a fertile environment for investment. Dramatic swings in investor sentiment provide opportunities for patient investors to buy into some great companies at attractive prices.

Chart sources: Australian Bureau of Statistics, Reserve Bank of Australia, Bloomberg, Auscap

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