Quarterly Review

China: 5 Days, 5 Cities, 5 Insights and 1 Conclusion

December 2018

In late 2018, Nick Pashias, Antares' Co-head of Equities, travelled through China, as part of an investor trip, to further Antares' understanding of the current business climate and how it relates to our investments; particularly in the resource sector.

He visited Beijing, Tangshan, Shanghai, Shenzhen and Hong Kong, met with over 20 companies and industry experts from the construction, real estate and steel making sectors.

Nick came away more negative on the outlook for raw material demand over the next few months leading into Chinese New Year. His five key insights were:

- The "Winter Cuts", at this stage, are not as bad as last year;
- Property prices are just about to roll over;
- Auto and Appliance demand is weak;
- Where steel margins go, iron ore follows; and
- Infrastructure is the hope, but is it enough?

His detailed summary follows:

The Winter Cuts, at this stage, are not as bad as last year

Although early in the winter period, it seems that Chinese steelmakers are more relaxed about the winter shuts versus our trip at the same time last year. It appears that the closure of mills has been left to the local governments in contrast to last year when the central government demanded closures across the board. Unlike last year there was no talk of pre-emptive closures so as to avoid government scrutiny.

Steel makers this year have been ranked into four groups (A to D) depending on their emission standards, finished product quality and mode of transport to market. Depending on the air quality, different groups will be instructed to curtail production, with group D (the biggest polluters) expected to take the biggest hit to production. Industry experts expect closures this winter period to run at around 10-15% of production compared to 30% last year, leading to more supply, but in a period of softer demand.

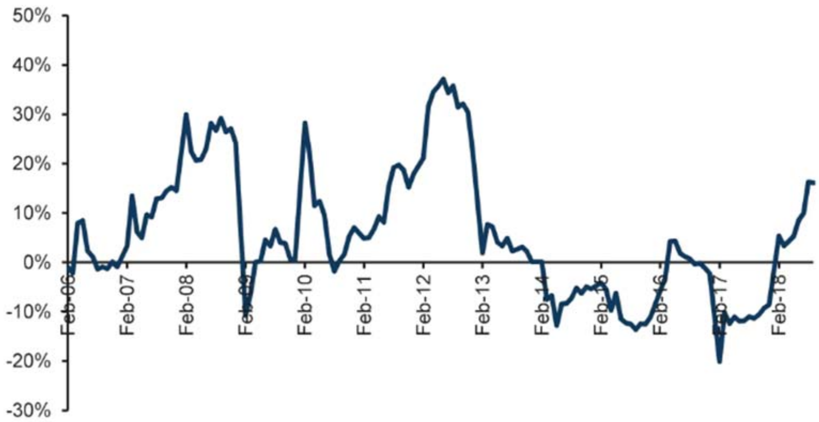
Some even suggested that the relaxed closures were a tool to maintain GDP growth with little regard for air quality.

Another popular theme was the impact of investment in emission control technology which has allowed mills to reduce emissions while maintaining production. Figures 1 and 2 illustrate the industry, aided by high margins over the last twelve months, has invested substantially in capital.

Figure 1: Steel capex in China

Source: WIND, Citi Research; October 2018

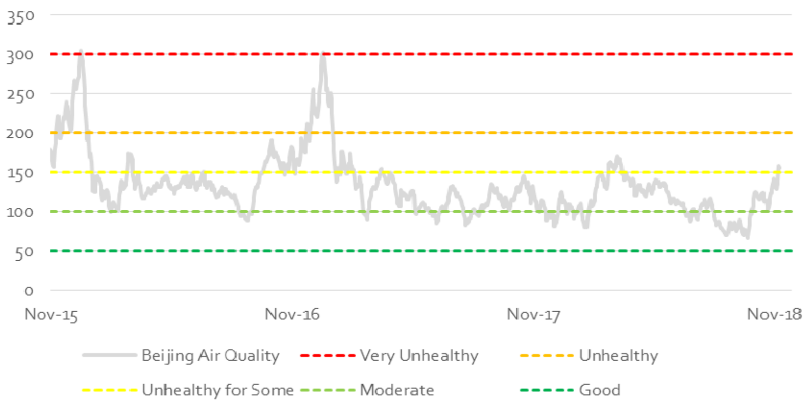
Figure 2: Growth in steel capex (%)



Source WIND, Citi Research; October 2018

On our return to Melbourne we looked at the available data relating to air quality around Beijing. Clearly evident in Figure 3 is the spike in emissions during November/December for 2015 and 2016. More interesting is the absence of any spike during winter 2017, a clear success for the central government. Although early in the current season it appears we are heading into a higher (more polluted) period. Figure 4 illustrates the year on year growth which at this stage has shown a dramatic increase over 2017 levels; indicating that the winter cuts are not potentially being enforced with the same rigour as 2017 and lending some weight to the argument that the steel industry is not curtailing production to sustain broader economic growth at a time of uncertainty.

Figure 3: China air quality index – Beijing (20DMA)



Source: Antares Equities, Bloomberg; November 2018

Figure 4: China Air Quality Index - Beijing Y-o-Y

Source: Antares Equities, Bloomberg; November 2018

Property is about to roll over

With property consuming around 40% of steel demand, it remains the most important sector in setting the price of steel and iron ore prices.

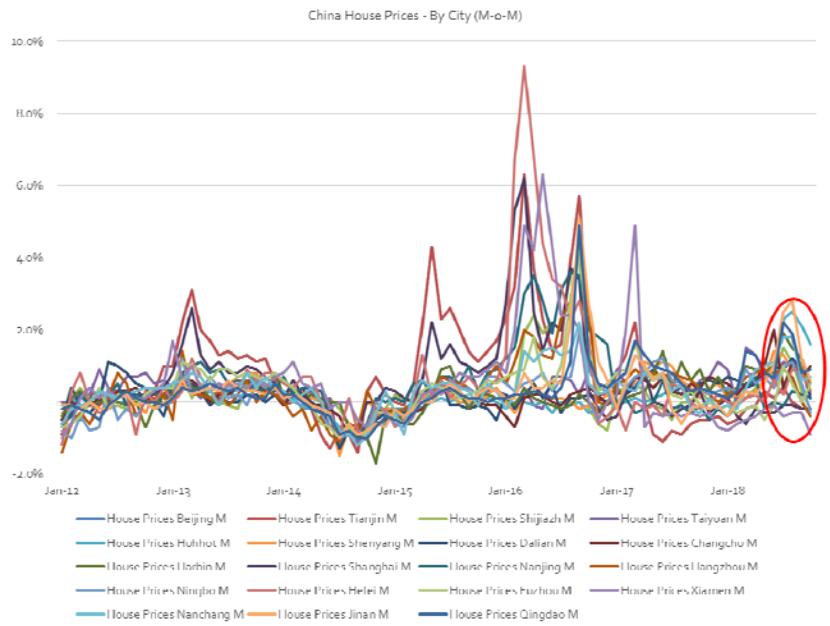
Over the years we have closely scrutinised data relating to property sales, starts, completions etc, but our experience suggests that house prices are generally the best predictor of property demand.

During the trip we met with a number of industry participants who were all generally cautious on prices. As we know 12-18 months ago the Chinese government embarked on a strategy to contain property prices. These home price restrictions coupled with the current uncertainty around trade wars looks to have generally finally dented demand for property and prices look to have been rolling over in the last few months. We have illustrated month on month growth in home prices around China in Figure 5. The downward trend is evident and clearly shown in Chart 6 that illustrates the high/low/average monthly numbers.

Over coming months we expect this to accelerate. There is anecdotal evidence that property developers are facing a liquidity squeeze and are liquidating inventory at lower prices. There were also stories of increasing land unsold (from local government) - the percentage of land being sold at zero premium to reserve prices is also up 10% on last year.

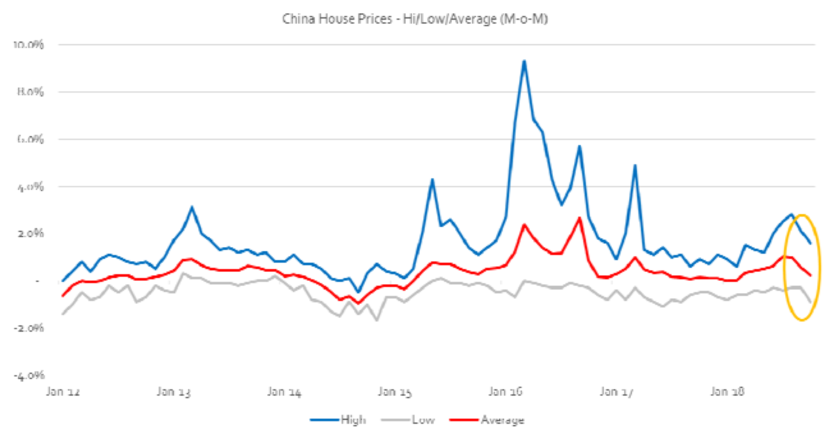
Office and commercial property demand also seems to be declining with new A-grade office supply expected to be down by 30% over the next few years.

Figure 5: China House Prices by City



Source: Antares Equities, Bloomberg; November 2018

Figure 6: China House Prices – Hi/Low/Average (M-o-M)



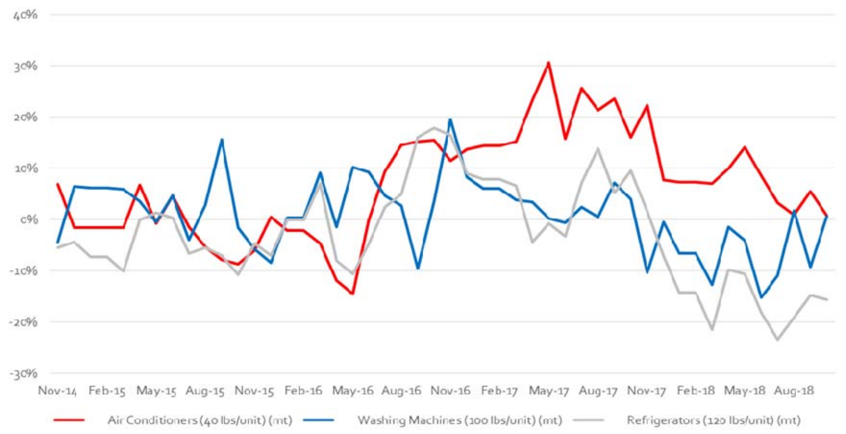
Source: Antares Equities, Bloomberg; November 2018

Auto and Appliance demand is weak

There was universal feedback regarding the weakness in white good and auto demand. Together these sectors make up approximately 10% of Chinese steel demand.

Year on year growth for these sectors is illustrated below. Whitegoods demand has been declining for most of 2018 with refrigerator demand being the weakest, down around 20%.

Figure 7: Whitegoods Demand (Y-o-Y)

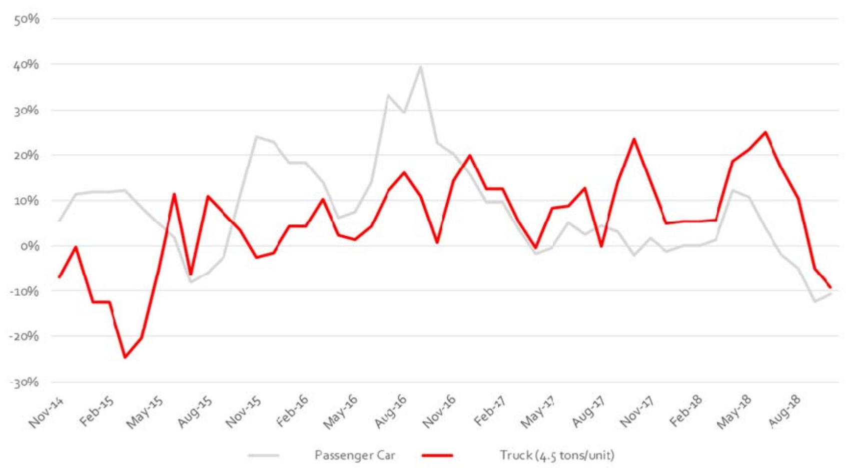


Source: Antares Equities, Bloomberg; November 2018

Following a series of initiatives designed to increase auto demand it looks like there has finally been buyer fatigue with the last data being down around 10% on last year for both passenger and truck vehicles.

Discussions with aluminium producers also suggest Chinese car manufacturers potentially intend to greatly increase the proportion of aluminium in cars from next year.

Figure 8: Vehicle Demand (Y-o-Y)



Source: Antares Equities, Bloomberg; November 2018

More broadly, weakness in appliances and passenger vehicles may indicate that the Chinese consumer is fatigued or reluctant to make some of these larger purchases due to uncertainty relating to the trade war.

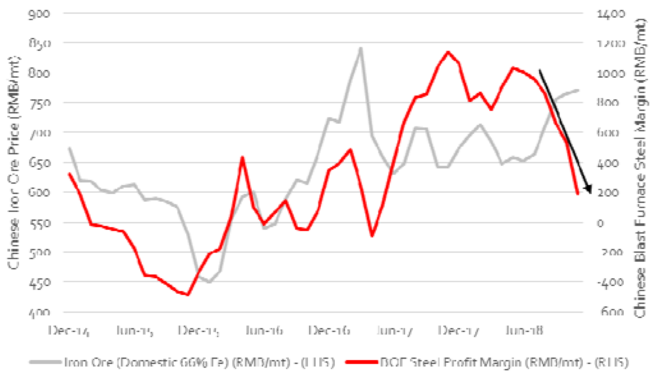
Where steel margins go, Iron Ore follows

A number of the steel mills we met with, particularly those producing hot rolled coil steel (used in appliance and auto manufacturing), were quite negative; which is no surprise given the large drop in margin experienced over the last few months. As illustrated in Figure 9, margins have fallen from around 1,000 RMB/t in June 2018 to 200 RMB/t in November 2018, some even suggested that on a spot price basis the larger State owned steel mills would potentially be loss making.

Over the years we have learned that the price of iron ore, at least in the short term, is not determined so much by supply and demand as it is by the steel mills ability to pay for the raw material. Their ability to pay is driven by their own margin. Figure 10 illustrates this relationship over the last four years. Spread margins lead the iron ore price.

We conducted further analysis on this correlation to determine the lead of steel mill margins ahead of the iron ore price, the analysis is presented in Figure 10 and suggests that there is generally a 1-2 month lag between steel mill spreads and the iron ore price. Figure 9 also suggests there is more room for the iron ore price to fall (at time of writing).

Figure 9: Chinese Iron Ore Price vs China BOF Margin



Source: Antares Equities, Bloomberg; November 2018

Figure 10: Iron Ore vs China BOF Margin Correlation

Source: Antares Equities, Bloomberg; November 2018

One additional note; over the last year or so we have heard BHP, RIO and Vale all suggesting that the discount of low grade material is structural not cyclical. We on the other hand have chosen a wait and see attitude. Figure 11 suggests the wait is over. The discount of low grade material remains cyclical. The determinant of the discount is influenced by the objective of the steel mills. Do they want to maximise production or profits? If production is to be maximised, and profits are high then high grade material is preferred and the discount will expand, however in times of low profits, the value in use of the low grade material is preferred and the discount should close, exactly as it has in the last few weeks.

Figure 11: Low Grade Iron Ore Discount

Source: Antares Equities, Bloomberg; November 2018

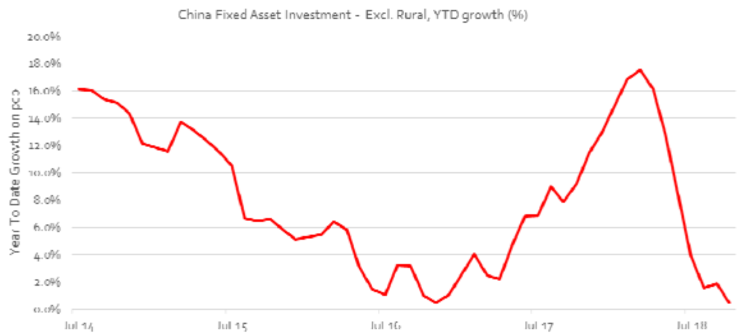
Infrastructure is the hope

Infrastructure spending has been the government's tool of choice over recent years to accelerate growth. Sometimes successfully, sometimes with unintended consequences. It seems we are possibly about to embark on another round of stimulus. The NDRC has recently approved a growing list of projects, not all with available funding.

At this stage it remains unclear how large the stimulus will potentially be but our feeling is that it is smaller than previous campaigns and will unlikely impact the real economy before Chinese New Year.

We visited each of the four largest infrastructure builders in China and although all were hopeful there remains some scepticism about the magnitude and timing of the initiative. The one clear point was that, following the government and local government bond issuance over the last several months, they were now being paid for the work they have done. What remains unclear is the quantum of funds available to deploy into future projects.

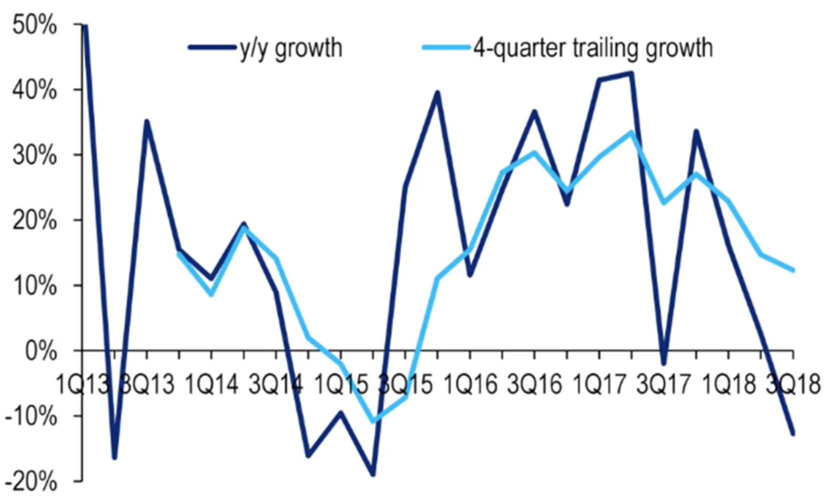
Figure 12: China Fixed Asset Investment – Excl Rural, YTD growth (%)



Source: Antares Equities, Bloomberg; November 2018

Third quarter order book intake from China's largest infrastructure companies is presented in Figure 13. Order intake was down 13% on the same period last year, hardly a ringing endorsement of future growth. Most of the companies we met did expect the fourth quarter (which is the largest quarter) to generally show growth on the previous corresponding period.

Figure 13: Order intake of the construction contractors



Source: Company reports, Citi Research; October 2018

Conclusion: The outlook for commodities is deteriorating

We believe that the demand for commodities is possibly going to deteriorate over coming months, beyond consensus expectations. Although the recent events at the G20 meeting have caused a cease-fire in the trade war between the US and China, there are more negotiations to be had and we expect uncertainty will persist for a while longer. With this backdrop we feel that our observations will continue to play out over the coming months. We continue to invest using the insights generated from our on the ground observations and bottom up fundamental analysis.

Antares market & fund updates

Below is a brief review of how the Australian share market performed during the quarter as well as short commentaries on each Antares Fund, outlining their net performance and the main contributors to performance.#

Australia share market review

The December quarter was brutal for global equity markets. The MSCI World Ex Australia Index (unhedged in AUD) fell by 11.1%, led by Japan's Nikkei 225 down 17%, with the US S&P 500 down 14.0% and the FTSE 100 off by 10.4%.

A combination of concerns weighed on global shares including the escalating trade war between China and the US, higher US interest rates, China's growth slowdown as well as European political risks including Brexit and the "yellow vests" in France.

Australian economic data was mixed with concerns over global trade tensions and the softer local housing market being counterbalanced by solid employment growth. However consumers appear to be cautious as seen in sedate retail spending. House prices continue to fall in both the Sydney and Melbourne markets after an extended boom. The Reserve Bank of Australia (RBA) has again kept the cash interest rate steady at 1.5%.

Australian shares (as measured by the S&P/ASX 200 Accumulation Index) fared better than most markets, but still posted their worst quarterly return since 2011, finishing down by 8.2% for the quarter. Energy was the poorest performer with the sector down by 21.3% as the oil price tumbled. The Consumer Discretionary sector also endured a sharp decline (-14.5%) given concerns over whether Australian consumers will restrict their spending in the light of falling house prices and tighter credit. Property was a relative bright spot (-1.8%) as were other defensive sectors.

Australian Equities Fund

The Antares Australian Equities Fund returned -8.3% (net of fees) for the December 2018 quarter, underperforming its benchmark S&P/ASX200 Accumulation Index return of -8.2% by 0.1%[1]. The main contributors to quarterly performance were an overweight position in Newcrest Mining, the decision not to own Lendlease and an underweight holding in Woodside Petroleum. Detracting from performance were overweight holdings in Nine Entertainment, Santos and AMP.

Dividend Builder

Antares Dividend Builder returned -6.8% (net of fees) for the December 2018 quarter, outperforming its benchmark S&P/ASX200 Industrials Accumulation Index return of -8.3% by 1.5%[1]. The main contributors to quarterly performance relative to the benchmark were overweight positions in Sydney Airport and Spark Infrastructure and the decisions not to own Lendlease. Detracting from relative performance was the decision not to own Woolworths and overweight holdings in AMP and Viva Energy.

Elite Opportunities Fund

The Antares Elite Opportunities Fund returned -11.8% (net of fees) for the December 2018 quarter, underperforming its benchmark S&P/ASX200 Accumulation Index return of -8.2% by 3.6%[1]. Detracting from performance was an underweight position in Commonwealth Bank and overweight holdings in Healius and Santos. Contributing to performance were overweight holdings in Graincorp, Northern Star and Healthscope.

High Growth Shares Fund

The Antares High Growth Shares Fund returned -11.5% (net of fees) for the December 2018 quarter, underperforming its benchmark S&P/ASX200 Accumulation Index return of -8.2% by 3.3%[1]. Underweight holdings in Lendlease and Domino's Pizza as well as an overweight holding in Northern Star contributed to performance, while overweight positions in BlueScope Steel, Boral, and Santos detracted from performance.

Listed Property Fund

The Antares Listed Property Fund returned -5.6% (net of fees) for the December quarter, underperforming its benchmark S&P/ASX200 A-REIT Accumulation Index return of -1.9% by -3.7%[1]. Contributing to performance were overweight holdings in VitalHarvest, Sydney Airport and Convenience Retail. Overweight holdings in Unibail-Rodamco-Westfield, Stockland and Peet all detracted from performance.

#All returns are net of fees. Please refer to page 3 for a summary of returns which are gross of fees. 1. Past performance is not a reliable indicator of future performance. Returns are not guaranteed and actual returns may vary from any target returns described in this document.

Antares Investments Returns

Performance to 31 December 2018[1]

Professional Selection		1 mth %	3 mths %	1 yr %	3 yrs % pa	5 yrs % pa	10 yrs % pa	Since Inception % pa
Antares Australian Equities Fund	Net Return	-1.3	-8.3	-6.3	6.3	5.4	8.8	9.0
S&P/ASX 200 Acc Index	Gross Return	-1.2	-8.2	-5.6	7.2	6.3	9.7	9.9
	Benchmark Return	-0.1	-8.2	-2.8	6.7	5.6	9.0	8.9
	Net Excess Return	**-1.2**	**-0.1**	**-3.5**	**-0.4**	**-0.2**	**-0.2**	**0.1**
	Gross Excess Return	**-1.1**	**0**	**-2.8**	**0.5**	**0.7**	**0.7**	**1.0**
Antares Dividend Builder	Net Return	-1.0	-6.8	-9.1	1.6	4.5	10.5	6.6
S&P/ASX 200 Industrials Acc Index	Gross Return	-0.9	-6.6	-8.6	2.2	5.1	11.2	7.3
	Benchmark Return	-1.4	-8.3	-4.2	3.9	6.2	10.7	6.9
	Net Excess Return	**0.4**	**1.5**	**-4.9**	**-2.3**	**-1.7**	**-0.2**	**-0.3**
	Gross Excess Return	**0.5**	**1.7**	**-4.4**	**-1.7**	**-1.1**	**0.5**	**0.4**
Antares Elite Opportunities Fund	Net Return	-2.5	-11.8	-6.5	6.6	6.1	9.5	10.1
S&P/ASX 200 Acc Index	Gross Return	-2.4	-11.6	-5.9	7.3	6.8	10.3	11.0
	Benchmark Return	-0.1	-8.2	-2.8	6.7	5.6	9.0	8.7
	Net Excess Return	**-2.4**	**-3.6**	**-3.7**	**-0.1**	**0.5**	**0.5**	**1.4**
	Gross Excess Return	**-2.3**	**-3.4**	**-3.1**	**0.6**	**1.2**	**1.3**	**2.3**
Antares High Growth Shares Fund	Net Return	-1.9	-11.5	-4.1	7.3	6.8	9.9	10.4
S&P/ASX 200 Acc Index	Gross Return	-1.8	-11.3	-3.1	8.4	7.9	11.2	11.9
	Benchmark Return	-0.1	-8.2	-2.8	6.7	5.6	9.0	7.6
	Net Excess Return	**-1.8**	**-3.3**	**-1.3**	**0.6**	**1.2**	**0.9**	**2.8**
	Gross Excess Return	**-1.7**	**-3.1**	**-0.3**	**1.7**	**2.3**	**2.2**	**4.3**
Antares Listed Property Fund	Net Return	0.5	-5.6	-4.2	4.3	10.2	9.5	7.8
S&P/ASX 200 A-REIT Acc Index	Gross Return	0.6	-5.4	-3.5	5.1	11.0	10.3	8.6
	Benchmark Return	1.7	-1.9	2.9	7.2	12.3	10.4	7.6
	Net Excess Return	**-1.2**	**-3.7**	**-7.1**	**-2.9**	**-2.1**	**-0.9**	**0.2**
	Gross Excess Return	**-1.1**	**-3.5**	**-6.4**	**-2.1**	**-1.3**	**-0.1**	**1.0**

Disclaimer:[1] Past performance is not a reliable indicator of future performance. Returns are not guaranteed and actual returns may vary from any target returns described in this document. Investment returns are based on exit prices, and are net of management fees and assume reinvestment of all distributions. Gross returns are provided to show performance against the investment objective.

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