Quarterly Review

Will the recent uptick in Chinese growth last?

antares

June 2016

The strength of the Chinese economy remains a key driver of commodity prices and the performance of Australian resource stocks. With early signs of some stabilisation in Chinese growth emerging in recent weeks, Antares' Portfolio Managers have just returned from a China research trip with new insights into the sustainability of the recent improvement in growth and what it implies for the iron ore market and, importantly, Australian resource stocks.

The information contained within this article is intended as factual information although we acknowledge that there is a reasonable likelihood of doubt and the information is not intended to imply any recommendation or opinion about a financial product.

China trip - where we went and why?

The main purpose of the trip was to assess the state of the Chinese economy and draw some conclusions about the sustainability of the recent improvement in leading indicators. These are important themes in an Australian equity context due to the significant impact that China has on commodity and resource markets through its resource demand. In particular, we focused on sectors that contribute most to steel demand as this is a major factor influencing the demand for iron ore from Australian producers.

One of the interesting aspects of China is that the economic situation can be quite diverse, depending on what part of the country you are visiting and the extent of urbanisation and development in any given city. Chinese cities are categorised by their level of development, with Tier 1 cities (Beijing, Shanghai) having the largest populations and the most developed services and infrastructure, whilst Tier 4 and 5 cities are smaller and less developed. So, in order to get a broad sense of how the economy is faring, the trip involved travelling to Tier 1, Tier 2, and Tier 3 cities across the country, with his major stops including Beijing, Shanghai, Zhengzhou and Jiaozuo.

The trip also involved visiting a broad range of companies and state owned enterprises across many different industries but with a definite focus on "old China" – i.e. the industrial sectors that drive the economy and have a huge impact on China's commodity demand. This includes consumer electronics, car manufacturers, steel producers and infrastructure companies.

We also visited property developers, given their pivotal role in steel demand, and several banks that provided some insights into the health of the financial system.

The main conclusion from the trip is that Antares are now more positive on the Chinese economy and the sustainability of the recent growth improvement, hence we have updated our steel and iron ore demand models to reflect this increased optimism. We are also more positive than the current consensus expectations in the market and this is important as "out of consensus" views often provide investment opportunities.

Sector and industry trends

Table 1 details China's total steel consumption by industry. If you combine the top four sectors – property, infrastructure, machinery and cars - you are looking at nearly 90% of China's total steel demand. So these sectors really matter, not only for the Chinese steel industry but also for Australian resource stocks because they generate demand for steel's major input – iron ore. Looking at recent trends in each of these sectors and what our research trip suggested about the near term outlook, we believe a significant recovery in Chinese steel demand is looming in the second half of the year.

Table 1: China's steel consumption by industry

Industry	% total steel consumption
Property	42%
Infrastructure	25%
Machinery	15%
Cars	6%
Ship building	3%
Whitegoods	2%
Other	7%

Source: Morgan Stanley Research, Antaike

Property - signs of a recovery emerging

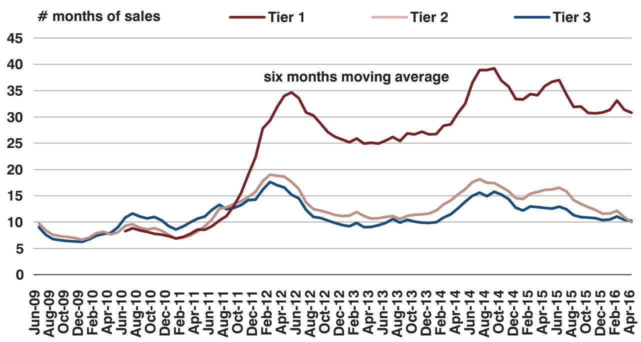
Recent indicators suggest some improvement in the property market which has started to respond to aggressive monetary policy easing from the People's Bank of China. Property prices were quite overheated in recent years but this has since corrected. Property sales and starts have been improving since late 2015 and are clearly on an upward trend as shown in Chart 1.

Chart 1: China property sales and construction starts

Source: CEIC, Morgan Stanley Research

Demand for property has picked up in response to monetary policy easing and this has helped to reduce the large inventory overhang which has been in place since early 2014. As Chart 2 shows, inventory levels in Tier 1 and Tier 2 cities have now moved back below historic averages which is very encouraging. In Tier 3 cities, inventory levels remain very high as over-building in the last property boom reached extreme levels. But the recent trend is moving in the right direction. As inventories normalise, the property construction cycle can begin again, and this should feed into higher steel demand.

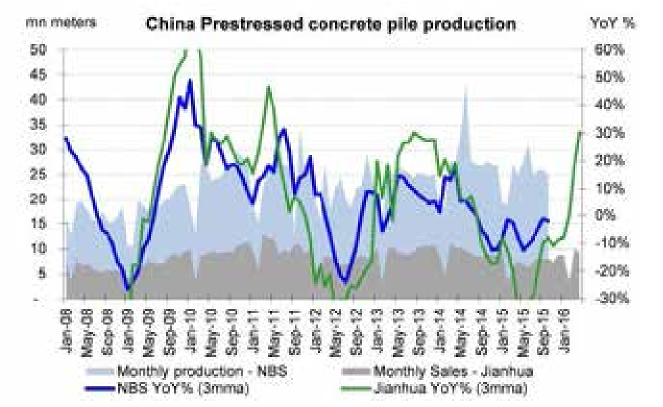
Chart 2: Property inventories – Tier 1, 2 & 3 cities



Source: Local Housing Bureaus, Soufun, CRR

The other important leading indicator of the property market that we monitor is the production of "pre-stressed concrete pile" which is used in the very early stages of construction in new buildings. Chart 3 shows that this indicator has accelerated rapidly since mid-2015 and is currently showing year-on-year growth of around 30%. This suggests the construction industry is in a recovery phase.

Chart 3: Property lead indicator – pre-stressed concrete pile



Source: CEIC, Morgan Stanley Research

Infrastructure – long duration projects bode well

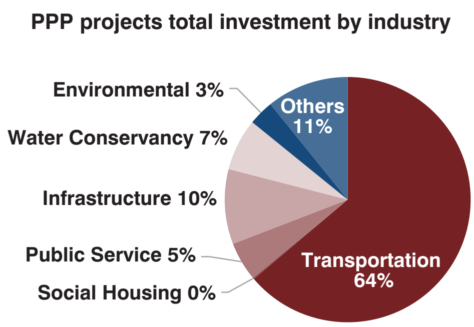
The infrastructure sector is starting to benefit from widespread infrastructure project announcements from the Chinese government.

According to Bank Credit Analyst data, recently announced infrastructure projects in China are budgeted to be more than the CNY14 trillion infrastructure package that was announced in 2008 in response to the GFC! So the scale of the stimulus is very significant. It is worth pointing out however, that the Chinese economy is now around 1.5 times larger than it was in 2008, so the positive effects of this infrastructure spending on economic growth may not be quite as great in a relative sense.

One significant difference between the infrastructure spending that is currently underway and the 2008 experience is that the government is now favouring Public Private Partnerships (PPP) to fund projects rather than bank debt. This is definitely more sustainable and puts less pressure on the already vulnerable financial system.

Chart 4 breaks down current PPP projects by sector, showing a huge bias towards transportation – roads, rail, ports, airports, bridges etc. This is partly due to the "One Belt, One Road" (OBOR) initiative which was quietly unveiled by the Chinese government in late 2013. OBOR seeks to open up the western part of China, making it a viable export route for Chinese companies. OBOR is a long term project (at least 5-10 years) that is still in its infancy and, to be successful, it will require large amounts of capital invested in roads, rail and sea transport.

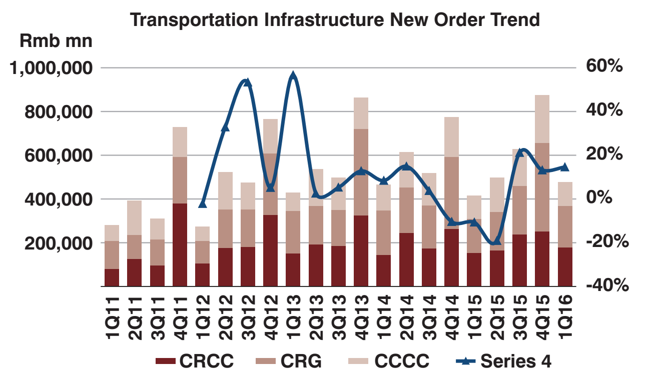
Chart 4: China PPP projects



Source: NDRC, Morgan Stanley Research

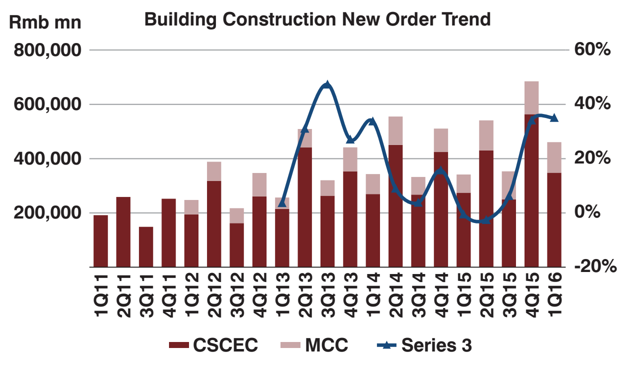
Charts 5 & 6 show recent trends in infrastructure order books for some of China's major infrastructure companies in the all-important transport and construction industries. The strength in new orders across transport and construction in recent quarters is very encouraging. Most of these projects have a long duration (3-4 years) and the bidding processes are taking place now. Duration is what is important about infrastructure projects in China – they take a long time, often several years, to complete. So they will provide an ongoing source of demand for steel which, in turn, is positive for the longer term iron ore outlook.

Chart 5: Transport infrastructure new orders as reported by large infrastructure construction groups



Source: Company data, Morgan Stanley Research

Chart 6: Building construction new orders as reported by construction companies



Source: Company data, Morgan Stanley Research

Machinery – a dual indicator

Chart 7 shows that a very strong recovery in machinery sales has occurred in the past 6 months. Machinery is important as it has a dual role with respect to its impact on steel demand:

- machinery production generates demand for steel; and
- the machinery that is produced (excavators, loaders, cranes etc.) is then used in the construction industry that generates its own steel demand.

So the pick-up in machinery sales that is evident in Chart 7 also suggests some improvement in other areas of the economy is underway.

Chart 7: China machinery sales

Source: CEIC, Morgan Stanley Research

Car manufacturing – strong consumer demand

Passenger vehicle sales in China are tracking very strongly so far in 2016 as shown by the dark red bars in Chart 8. With annual growth averaging close to 10% in recent months, the car manufacturing sector looks likely to remain a significant contributor to steel demand in the foreseeable future.

Chart 8: China passenger vehicle sales

Source: CAAM, Morgan Stanley Research

Steel demand and supply – implications for Australian iron ore

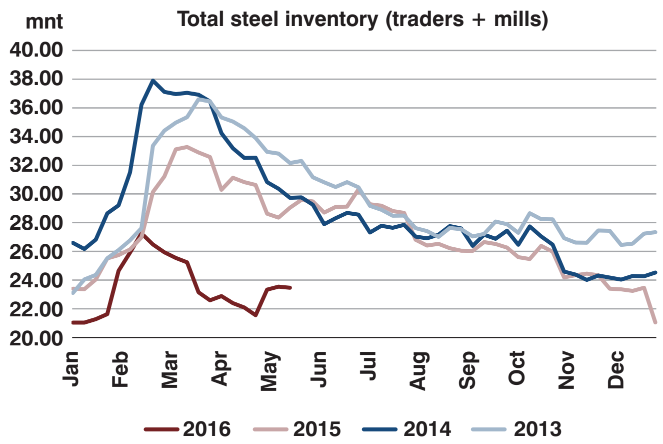
Our trip confirmed what the above leading indicators are suggesting – the property, infrastructure, machinery and auto sectors are all in various stages of recovery. So what does this mean for Antares' China view?

Antares models China's steel demand as part of our research into Australian resource companies. The model makes assumptions about the growth rates of the major sectors of the Chinese economy – property, infrastructure, cars, machinery, appliances and ship building – to estimate China's domestic steel demand growth. This is then combined with an estimate of China's net steel exports to obtain a total demand growth figure. The model estimates both an upside scenario and a downside scenario, to give a range of expected outcomes. To translate these steel demand projections into iron ore demand forecasts, we use a multiplier that adjusts for how much iron ore is used to create one tonne of steel.

Following the China trip, this model was updated to reflect Antares' more positive view on the infrastructure, property, machinery and auto sectors. **The model now suggest that China's steel demand can grow between 1% and 4% in 2016 which is significantly above the prevailing consensus expectation of -4% to flat.**

Current steel inventories appear to be very low based on historical patterns as detailed in Chart 9. So there is clearly no inventory overhang at present. We also expect some of the major iron ore companies to produce at lower levels in 2016 compared to 2015 (e.g. Chinese domestic producers, Vale and some smaller producers) which could see total iron ore supply fall short of last year's levels. This would be positive for the iron ore price if it coincides with the stronger Chinese steel demand that we are currently forecasting.

Chart 9: China steel inventories (traders & mills)



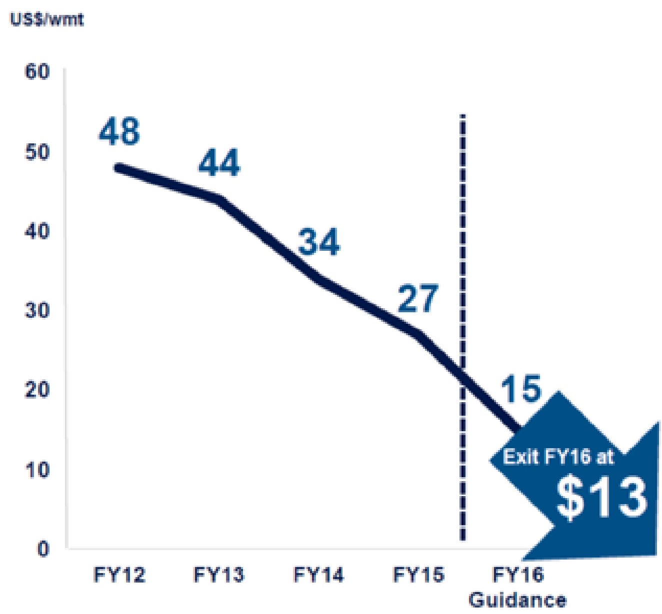
Source: Mysteel, CISA, Morgan Stanley Research

So, in summary, our recent China research trip has made us more optimistic on the growth environment and enabled us to revise up our Chinese steel demand projections for 2016 to above consensus levels. If realised, this stronger steel demand should improve the outlook for iron ore prices in the second half of 2016, suggesting the recent iron ore price improvement may have further to run. This is clearly positive for some of Australia's major mining stocks.

Antares portfolio implications

As a result of the trip and our improved confidence in the outlook, we have introduced Fortescue Metals Group (FMG) into some of Antares Equities' share portfolios. FMG is a pure play iron ore producer that has materially lowered its costs over the past few years. As Chart 10 shows, just 4 years ago, FMG's cost (C1) per tonne of iron ore was $US48 but in FY16 it is expected to be only US$13. This is an amazing transformation that makes FMG one of the lowest cost iron ore producers globally.

Chart 10: FMG cost (C1) per tonne of iron ore



Source: Morgan Stanley Research, Antaike

As iron ore prices rise in coming months, in response to the improved outlook for Chinese steel demand that we are forecasting, we also expect FMG to continue to deleverage its balance sheet. This would reduce the risk associated with the stock and improve the risk/return trade-off, leading to further potential for share price appreciation.

Antares market & fund updates

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

Australian sharemarket review

The Australian sharemarket outperformed global markets in the June quarter, with the S&P/ASX 200 Accumulation Index rising 3.9%. The market was supported by the Reserve Bank of Australia's decision to cut official interest rates by 0.25% to 1.75% in response to weaker than expected inflation data. However, uncertainty over the Federal election and Brexit negatively impacted the market late in the quarter.

The best performing sector was resources (+11.5%) that was boosted by stronger commodity prices. Major iron ore producers, BHP Billiton (BHP) and Rio Tinto (RIO), reduced production and shipment expectations and this supported the iron ore price. The healthcare sector (+10.2%) benefited from the weaker Australian dollar given its US dollar revenues and defensive sectors, such as REITs (+7.2%) and telecoms (+4.2%) also outperformed.

Consumer staples (-3.6%) and banks (-1.2%) were the only sectors to deliver negative returns. First half results were released by ANZ Banking Group (ANZ), National Australia Bank (NAB) and Westpac Banking Corporation (WBC). The main focus was on provisioning which was generally higher but not as bad as investors feared.

Companies with significant UK exposure were sold down aggressively given the uncertain implications of Brexit. This includes Henderson Group, CYBG (Clydesdale Bank), QBE Insurance Group, BT Investment Management, Computershare and Macquarie Group.

Australian Equities Fund

The Antares Australian Equities Fund returned 2.3% (net of fees) for the June quarter, underperforming its benchmark S&P/ASX 200 Accumulation Index return of 3.9% by 1.6%. The main contributors to performance for the Portfolio over the quarter were overweight positions in Santos and Aristocrat Leisure. An overweight positions in AMP and not holding a position in CSL detracted from performance.

Dividend Builder

Antares Dividend Builder delivered a return of 1.5% (net of fees) for the June quarter, underperforming the benchmark S&P/ASX 200 Industrials Accumulation Index return of 2.8% by 1.3%. The main contributors to performance for the Portfolio over the quarter were overweight positions in Aurizon Holdings and Stockland. The main detractors from performance over the quarter were overweight positions in AMP and JB Hi-Fi.

Elite Opportunities Fund

The Antares Elite Opportunities Fund returned 1.7% (net of fees) for the June quarter, underperforming the benchmark S&P/ASX 200 Accumulation Index return of 3.9% by 2.2%. The main contributors to performance for the Portfolio were overweight positions in Aristocrat Leisure and WorleyParsons. The main detractors from performance over the quarter were overweight positions in Qantas Airways and Mantra Group.

High Growth Shares Fund

The Antares High Growth Shares Fund returned 2.1% (net of fees) for the June quarter, underperforming its benchmark S&P/ASX 200 Accumulation Index return of 3.9% by 1.8%. Contributing positively to performance during the June quarter were an overweight position in Aristocrat Leisure and an underweight position in Orica. The main detractors from performance were an overweight position in Qantas Airways and an underweight position in BHP Billiton.

Small Companies Fund

The Antares Small Companies Fund delivered a return of 4.2% (net of fees) for the June quarter, underperforming the benchmark S&P/ASX Small Ordinaries Accumulation Index return of 5.8% by 1.6%. The main contributors to performance for the Portfolio were an overweight position in Evolution Mining and not holding a position in Blackmores. Detracting from performance were overweight positions in Mantra Group and BT Investment Management.

Australian Shares Fund*

The Antares Australian Shares Fund delivered a return of 2.3% (net of fees) for the June quarter, underperforming the benchmark S&P/ASX 200 Accumulation Index return of 3.9% by 1.6%. The main contributors to performance for the Portfolio over the quarter were overweight positions in Santos and CYBG. Overweight positions in AMP and Qantas Airways detracted from performance.

Listed Property Fund

The Antares Listed Property Fund delivered a return of 8.8% (net of fees) for the June quarter, underperforming the benchmark S&P/ASX 200 A-REIT Accumulation Index return of 9.2% by 0.4%. Positively contributing to performance during the quarter were overweight positions in Iron Mountain and Aventus Retail Property Fund. The Fund's performance was negatively impacted by an underweight position in Dexus Property Group and an overweight position in Peet.

All returns are net of fees. Please refer to page 6 of the Quarterly Review for a summary of returns which are gross of fees.
* Closed to new investments

Antares Investment Returns
Performance to 30 June 2016[1]

		3 mths %	1 yr %	3 yrs % p.a.	5 yrs % p.a.	10 yrs % p.a.	Since Inception % p.a.
Australian Equities							
Australian Equities Fund Inception date: 03/07/1995	Net return[2]	2.3	-2.2	6.5	6.6	5.1	9.2
	Gross Return[3]	2.5	-1.3	7.4	7.5	6.0	10.1
	Benchmark Return	3.9	0.6	7.7	7.4	4.9	9.1
	Net Excess Return	**-1.6**	**-2.8**	**-1.2**	**-0.8**	**0.2**	**0.1**
	Gross Excess Return	**-1.4**	**-1.9**	**-0.3**	**0.1**	**1.1**	**1.0**
Dividend Builder Inception date: 06/09/2005	Net return[2]	1.5	-0.5	9.4	12.6	7.3	7.6
	Gross Return[3]	1.7	0.1	10.0	13.3	7.9	8.2
	Benchmark Return	2.8	2.9	10.3	13.1	6.6	7.3
	Net Excess Return	**-1.3**	**-3.4**	**-0.9**	**-0.5**	**0.7**	**0.3**
	Gross Excess Return	**-1.1**	**-2.8**	**-0.3**	**0.2**	**1.3**	**0.9**
Elite Opportunities Fund Inception date: 18/11/2002	Net return[2]	1.7	3.1	8.3	6.7	6.2	10.6
	Gross Return[3]	1.9	3.8	9.0	7.5	7.0	11.5
	Benchmark Return	3.9	0.6	7.7	7.4	4.9	8.8
	Net Excess Return	**-2.2**	**2.5**	**0.6**	**-0.7**	**1.3**	**1.8**
	Gross Excess Return	**-2.0**	**3.2**	**1.3**	**0.1**	**2.1**	**2.7**
High Growth Shares Fund Inception date: 07/12/1999	Net return[2]	2.1	1.7	7.9	7.5	6.3	10.6
	Gross Return[3]	2.3	2.8	9.0	8.7	7.5	12.1
	Benchmark Return	3.9	0.6	7.7	7.4	4.9	7.7
	Net Excess Return	**-1.8**	**1.1**	**0.2**	**0.1**	**1.4**	**2.9**
	Gross Excess Return	**-1.6**	**2.2**	**1.3**	**1.3**	**2.6**	**4.4**
Small Companies Fund Inception date: 19/11/1999	Net return[2]	4.2	14.3	7.9	2.5	6.2	9.6
	Gross Return[3]	4.5	15.4	8.9	3.5	7.2	10.6
	Benchmark Return	5.8	14.4	9.1	1.0	1.1	4.3
	Net Excess Return	**-1.6**	**-0.1**	**-1.2**	**1.5**	**5.1**	**5.3**
	Gross Excess Return	**-1.3**	**1.0**	**-0.2**	**2.5**	**6.1**	**6.3**
Listed Property							
Listed Property Fund Inception date: 28/02/1994	Net return[2]	8.8	23.1	17.2	17.4	4.8	8.7
	Gross Return[3]	9.0	24.0	18.0	18.2	5.5	9.5
	Benchmark Return	9.2	24.6	18.5	18.1	3.1	8.2
	Net Excess Return	**-0.4**	**-1.5**	**-1.3**	**-0.7**	**1.7**	**0.5**
	Gross Excess Return	**-0.2**	**-0.6**	**-0.5**	**0.1**	**2.4**	**1.3**

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.
[2] Investment returns are based on exit prices, and are net of management fees and assume reinvestment of all distributions.
[3] Gross returns are provided to show performance against the investment objective.

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