Investor Update

Is China slowing and what does it mean for Australian resource stocks?

June 2017

China is on the radar once again as investors grapple with the growth implications of recent policy tightening that is designed to slow the overheating property market. Nick Pashias, Antares Co-Head of Equities, has just returned from another China research trip aimed at reassessing the growth outlook and the implications for Australia's iron ore producers given the property sector is the largest consumer of steel in the Chinese economy. This article details Nick's findings and the portfolio implications of his recent trip, with a strong focus on resource exposure given the leverage that Australian resource stocks have to the pace of Chinese growth.

The trip - why did we go and who did we see?

Antares generally does a China research trip twice a year as China dominates our region and is a significant driver of commodity prices and hence resource stock performance. The aim of these trips is not so much to determine if China's economy is strong or weak, but to analyse the incremental change since our last trip – has the economic environment improved or worsened since we were last there? We then compare our assessment of China with what we believe is priced into investors' expectations. If our view diverges from the consensus, then we are likely to find some interesting investment opportunities.

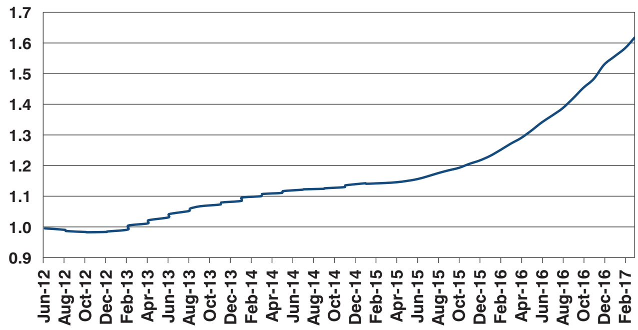
This trip to China took place in mid-May, with Nick visiting Beijing, Shanghai and Jinan (capital of Shandong Province). He spoke to 24 companies across a diverse range of industries including steel, power, base metals, coal, aluminium and property.

Property market potentially at tipping point

At the start of the trip, we were marginally positive on China but we came away being marginally negative. This shift in our perception was mainly due to the property market which we think is on the verge of a slowdown and with other sectors of the economy already doing well, it is unlikely the rest of the economy can fill the gap.

The problem for the property market is not end demand as the Chinese population are becoming wealthier and home ownership is regarded very highly. It's the government that is trying to engineer a property slowdown due to rapid house prices rises and the degree of leverage in the financial system. Chart 1 shows the average selling price index of houses in thirty of China's most significant cities. It's clearly been on a sharp upward trend in recent years and is up around 30% in the last 12 months. This trend, as yet, shows no sign of abating.

Chart 1: China 30 City Average Sales Price Index

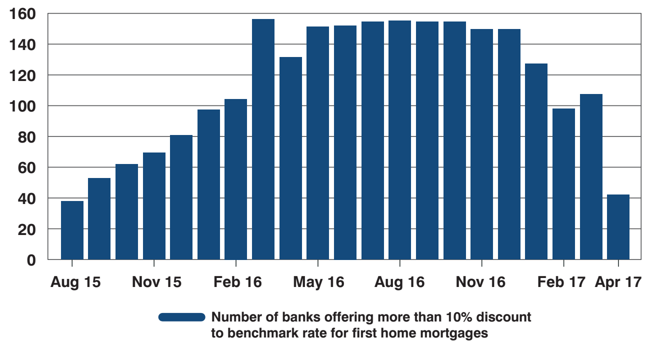


Source: Bloomberg, May 2017

When we last visited China in October 2016 the government had just started its first round of initiatives aimed at slowing the property market. In April/May 2017 the second round commenced and it is now that the impacts are starting to be felt. This policy tightening has been implemented at the central government level as well as the provincial level and includes measures such as:

- Limiting the number of properties a person can own (usually two).
- Increasing the required down-payment on second homes.
- Introducing price caps that developers cannot exceed when selling properties, even if a higher bidder exists.
- Making the approval process more stringent and longer.
- Increasing the interest rate that applies to borrowers – some borrowers used to be able to access funds at a 10-15% discount to the official interest rate but this is no longer allowed and in some cases borrowers are now paying a premium to the official rate. Chart 2 clearly shows the fall in the number of banks offering mortgage discounts in recent months.

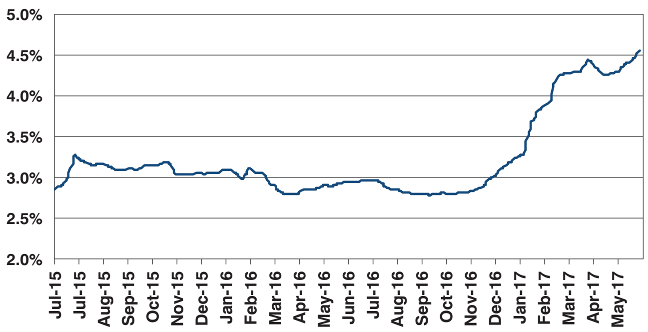
Chart 2: Mortgage discounts being withdrawn*



Source: Rong 360, Bloomberg, May 2017. * Sample of 533 banks.

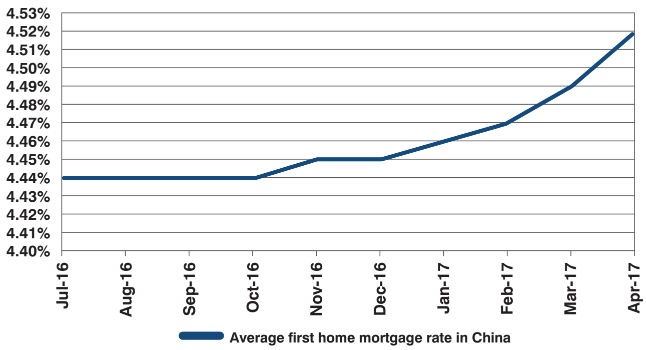
Whilst these are all incremental measures, they are starting to have an impact. There has also been a general tightening in liquidity, as seen in Charts 3 and 4 that show the upward trend in both the Shanghai interbank offered rate (SHIBOR) and the mortgage rate for first home buyers in China.

Chart 3: SHIBOR rate - 3 month



Source: Bloomberg, May 2017

Chart 4: Mortgage costs trending up*



Source: Rong 360, Bloomberg, May 2017. *Average of 35 major Chinese cities

The significance of a slowdown in the Chinese property market for Australian iron ore stocks should not be underestimated. This includes Fortescue Metals Group (FMG), Rio Tinto (RIO) and BHP Billiton (BHP). As Table 1 shows, the property market is by far the largest consumer of steel in the Chinese economy and a lot of this steel is produced using Australian iron ore!

Table 1: China's steel consumption by industry

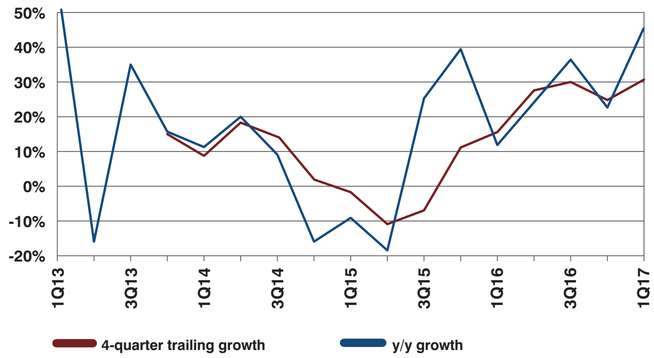
Industry	% total steel consumption
Property	**42%**
Infrastructure	**25%**
Machinery	**15%**
Cars	**6%**
Ship building	**3%**
Whitegoods	**2%**
Other	**7%**

Source: Morgan Stanley Research, Antaike, May 2016.

Iron ore price vulnerable again

The other sector that generates significant demand for iron ore is infrastructure and this continues to perform well. In fact, it's the opposite of the property market as the government is actively stimulating the infrastructure sector and this is generating significant growth. Chart 5 illustrates the strong order growth currently being experienced by Chinese infrastructure contractors.

Chart 5: Infrastructure contractor order intake (% year-on-year)



Source: Company reports, Citi Research, May 2017

The order books of some of the infrastructure related companies that we visited are currently showing year-on-year growth of 20-30%. However, this may not be enough to maintain recent levels of iron ore demand as other sectors of the economy are no longer performing as strongly. For example, the car manufacturers are experiencing considerably lower growth than they were six months ago (Chart 6).

Chart 6: Growth in car sales*

Source: Bloomberg, May 2017. *3 month rolling average of year-on-year growth rate.

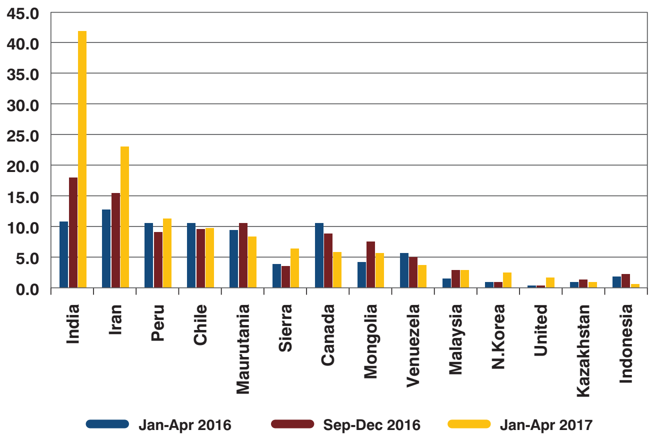
Our meetings with the major steel companies also suggested demand was slowing as the rate of growth in their order books has started to decline. Whilst this has not yet fed into the official Chinese economic data, we expect to see some impact in coming months.

Finally, there are two other subtle factors that are impacting demand for Australia's iron ore and these are less well understood by the market:

- *The closure of Chinese induction furnaces* – To date, there has been a mandated closure of induction furnaces amounting to around 50 million tonnes per annum of steel capacity. Induction furnaces only use scrap metal as an input (not iron ore), so now there is an oversupply of scrap in the Chinese market. This is enabling blast furnaces (that can use scrap or iron ore) to use scrap which is a cheaper source of iron than iron ore. This is a significant change in the structure of the Chinese steel industry that could have long run implications for Australia iron ore demand. This is discussed in more detail below.

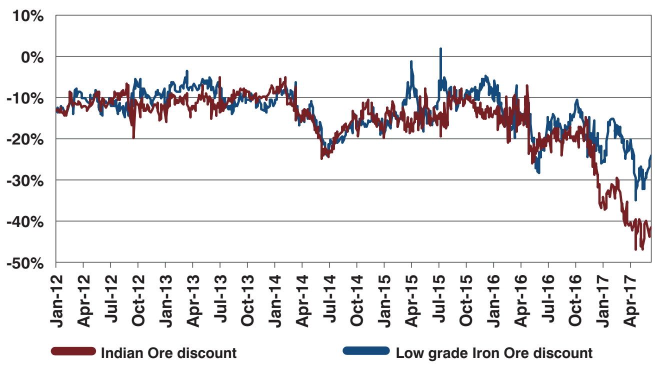
- *Indian iron ore exports* - India has started to export iron ore again after a government ban was lifted (see Chart 7 below). Indian iron ore tends to be low grade, hence it directly competes with the product produced by Fortescue Metals Group, and we have started to see a material discount in the price being received by FMG in recent months (see Chart 8). Investors are aware of this issue but we think the magnitude of the discount will widen further and surprise the market.

Chart 7: Iron ore production amongst minor producers



Source: Platts, May 2017

Chart 8: Iron ore pricing discounts to benchmark (62%)



Source: Platts, May 2017

So in summary, whilst the Chinese infrastructure sector remains strong, we believe the looming slowdown in property and potentially other sectors, makes the iron ore price vulnerable to more weakness. This is being reinforced by China's increasing use of scrap instead of iron ore as an input in steel furnaces and the return of India as an exporter of low grade iron ore. Furthermore, the traditional suppliers, such as BHP Billiton (BHP), Rio Tinto (RIO) and Vale, are all expected to increase production over the next 12 months.

From a portfolio perspective, the trip served to further justify our decision not to hold a position in FMG (we sold the stock in December 2016) which is vulnerable to the falling iron ore price as well as a widening in the discount applied to low grade iron ore in response to increased supply from India. Following the trip, we also moderately reduced our overweight position in RIO.

Other ongoing themes

We also revisited several other themes during our trip and our major observation was that the Chinese government appears more determined to succeed in these areas:

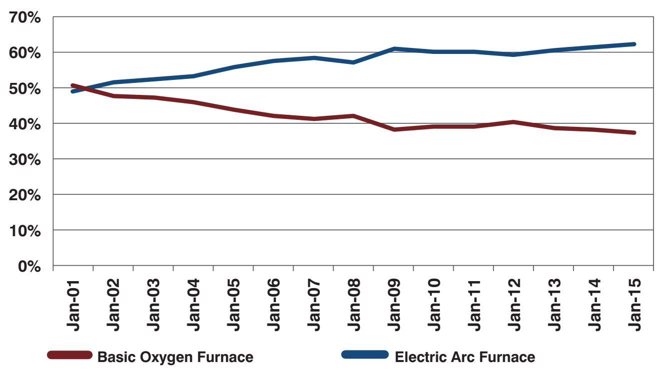
- *Supply side reforms* – This was initially limited to the steel and coal industries but has now spread to aluminium producers.
- *Environmental protection* – We are now more convinced that this is becoming a priority for the government, it's not just "talk".
- *Reform of state owned enterprises (SOEs)* – The government is actively trying to consolidate SOEs to create fewer, larger, more profitable businesses.
- *Gas* – It is becoming apparent that China is starting to unlock its shale resources. Some of our meetings suggested it is possible that future growth in China's gas demand will be met by internal production. If this proves to be true, it could have negative implications for Australian companies with LNG exposure (eg Santos, Woodside Petroleum, Origin Energy).

Scrap versus iron ore - has China's first "scrap cycle" begun?

The following question is the one that is really concerning us about the iron ore market: Does the recent shift towards the use of scrap as an input in steel production herald the beginning of China's first "scrap cycle"? To answer this question, we need to explain what the "scrap cycle" actually is.

Chart 9 shows how the major developed economies produce steel, using the US as an example. The chart shows that basic oxygen furnaces (~40% share) that run on iron ore are being superseded by electric arc furnaces (~60% share) that predominantly use scrap to produce steel. Scrap is abundant in most developed economies as they have been developing for so long that they have lots of old appliances and cars as well as old infrastructure, homes, buildings and factories to pull down and recycle – that's the scrap cycle, reusing old metal to create new steel. Scrap is currently cheaper than iron ore (and coke), so when scrap is so readily available, it makes good business sense to use it. It's also by far the best option for the environment.

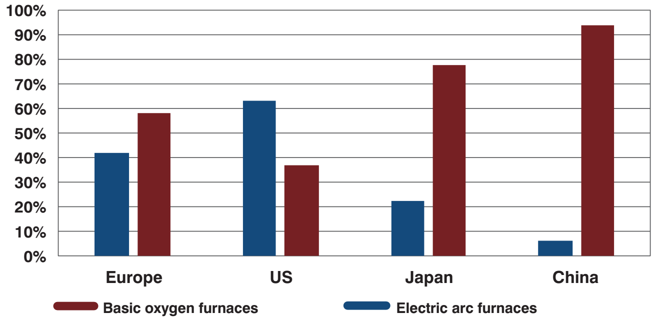
Chart 9: US steel production – electric arc versus basic oxygen furnaces



Source: Bloomberg, May 2017

By contrast, Chart 10 (overleaf) shows the breakdown of China's current steel production compared to the US, Europe and Japan. China still uses mostly basic oxygen furnaces (~90%) so there is scope for a huge change in Chinese steel production in coming years as China moves towards the dominance of electric arc furnaces like other developed countries.

Chart 10: Steel production comparison – electric arc versus basic oxygen furnaces



Source: Bloomberg, McKinsey, May 2017

In addition, China has always been viewed as such a newly industrialising nation that it didn't have excess scrap from old appliances, cars, infrastructure, homes and factories to recycle as scrap - everything made of steel was relatively new. But China has now been industrialising for 30-40 years, so perhaps there are now some old structures that can be pulled down and reused. So maybe we are on the cusp of China's first scrap cycle.

If this proves to be correct and China is moving towards a steel production structure similar to the rest of the developed world, then it is an extremely bearish long term development for Australia's iron ore producers. Demand for iron ore will fall significantly over time as relatively cheap scrap is increasingly used instead of iron ore. And, it won't just be a cyclical dip. This is a structural change to the industry, so the fall in demand will likely be permanent. To put the numbers into perspective, if China was to move to produce a similar percentage of its steel from electric arc furnaces as Japan (so just over 20%), it would require around 210m tonnes less iron ore per annum. And that is almost BHP's entire annual production!

China's increasing use of scrap also has implications for other Australian companies. Take Sims Metal Management (SGM) as an example. SGM's main business is scrap metal so if China's demand for scrap increases to such a level that it needs to import scrap, it is very positive for SGM. But what if China's scrap cycle is so big that it starts to export scrap to the rest of the world? Such a big increase in scrap supply would not be so good for SGM.

All these are longer term questions but the important issue for now is that we will be closely monitoring China's scrap demand in future. If China's scrap cycle has indeed begun, it represents a permanent industry shift which Australian iron ore producers are likely to have difficulty navigating.

2016-17 Financial Year – Market and Fund Reviews

Global and Australian economies

The US economy continued to strengthen and the Federal Reserve responded by implementing three 25 basis point policy tightenings in December, March and June. This lifted the federal funds rate target range to 1-1.25%. The election of President Trump in November shifted the focus to fiscal policy given his well-publicised infrastructure spending plans. However, the failure of Trump's healthcare reform agenda caused investors to question whether he actually has enough support to implement any significant reforms.

In Europe, the year commenced with widespread political uncertainty given Brexit, several looming elections and the rising popularity of the far right. This dissipated as the year progressed as the Italians voted "no" in their constitutional reform referendum, Austria rejected the far right in favour of a new centre left President and Emmanuel Macron was victorious in the French Presidential election. Stronger than expected economic data in the second half of the year suggested the region was recovering more rapidly than previously thought. This led to debate about when the European Central Bank would start to remove some of its policy stimulus.

Growth in Japan remained disappointingly weak, prompting the government to announce a ¥29t fiscal stimulus package and some changes to the Bank of Japan's (BOJ) monetary policy framework. The direction of the yen was also a major focus, with the currency depreciating significantly in late 2016 to end the year down 8.2% against the US dollar.

The Australian economy continued to grow moderately, with policy shifts mainly driven lower than expected inflation data. The Reserve Bank of Australia announced one final 0.25% interest rate cut in August, taking the official cash rate to an historic low of 1.5% where it remained for the rest of the year. The Australian dollar was volatile, given movements in commodity prices, but ended the year up 3% at around 77 US cents.

Global share markets

Global share markets performed very strongly in FY17 in response to accelerating global growth, favourable earnings and a gradual reduction in political uncertainty in Europe. In the US, the S&P 500 Index rose 15.5% despite three monetary policy tightenings from the Federal Reserve. Trump's election victory initially spurred a "reflation trade" in shares given his infrastructure spending plans but his failure to enact health care reform caused investors to reassess.

In Europe, German shares rose 27.3% and French shares rose 20.8% as investors shrugged off Brexit and focused on the stronger economic recovery and supportive central bank policies. Japan's Nikkei Index rose 28.6%, supported by yen depreciation and signs of stronger growth late in the year. China's Shanghai Composite Index rose 9.0% in response to signs of an improvement in growth.

Australian share market

The Australian share market performed well in FY17, with the S&P/ASX 200 Accumulation Index rising 14.1%. The materials sector (+26.0%) was a major contributor as stronger commodity prices (coal +42%; iron ore +17%) improved the earnings outlook. Bank stocks (+18.4) also outperformed as investors moved out of traditional interest rate sensitive stocks in late 2016 as 10-year bond yields rose. The announcement of interest rate rises by the major banks also improved the earnings outlook. Towards year-end, the banks were negatively impacted by the government's bank levy and concerns about a potential downturn in the domestic housing market.

Telecoms (21.7%) were very weak, dragged down intense competition and the NBN roll out that are negatively impacting earnings expectations. REITs also underperformed in response to higher domestic bond yields and the pending entry of Amazon into the domestic market given the impact this may have on shopping centre usage by consumers.

Below are short commentaries on each Antares fund, outlining their net performance and the main contributors to performance.#

Australian Shares Fund*

The Antares Australian Shares Fund delivered a return of 1.6% (net of fees) for the six months to June 30, underperforming the benchmark S&P/ASX 200 Accumulation Index return of 3.2% by 1.6%. Over the past 12 months, the Fund returned 15.9% (net of fees), outperforming its benchmark by 1.8%. The main contributors to relative performance over the past year were overweight positions in Computershare, Rio Tinto, Sims Metal Management and Qantas Airways. Detracted from yearly performance were overweight positions in Santos, Vocus Group and Healthscope. Holding some cash also detracted from relative performance given the strong rise in the share market.

Elite Opportunities Shares Fund*

The Antares Elite Opportunities Shares Fund returned 4.1% (net of fees) for the six months to June 30, outperforming the benchmark S&P/ASX 200 Accumulation Index return of 3.2% by 0.9%. Over the past 12 months, the Fund returned 16.0% (net of fees), outperforming its benchmark by 1.9%. Overweight positions in Rio Tinto, Computershare and Qantas Airways were the main positive contributors to relative performance over the year, along with an underweight position in Telstra Corporation. Being overweight Vocus Group, Santos and Healthscope detracted from relative performance, along with the decision not to hold a position in BHP Billiton that performed well.

High Growth Shares Fund*

The Antares High Growth Shares Fund returned 3.9% (net of fees) for the six months to June 30, outperforming the benchmark S&P/ASX 200 Accumulation Index return of 3.2% by 0.7%. Over the past 12 months, the Fund returned 16.0% (net of fees), outperforming its benchmark by 1.9%. The main contributors to relative performance over the year were overweight positions in Computershare, Aristocrat Leisure and South32, along with an underweight position in GPT Group. Detracting from annual performance were overweight positions in Vocus Group, Healthscope and Star Entertainment Group. Holding some cash in the Fund also detracted from relative performance given the strong rise in the share market.

Listed Property Fund*

The Antares Listed Property Fund delivered a return of -3.3% (net of fees) for the six months to June 30, outperforming the benchmark S&P/ASX 200 A-REIT Accumulation Index return of -3.7% by 0.4%. Over the past 12 months, the Fund returned -7.8% (net of fees), underperforming the benchmark index by 1.5%. The REIT sector was negatively impacted by a shift away from interest rates sensitive sectors given the rise in bond yields over the year. Overweight positions in Goodman Group, Asia Pacific Data Centre Group and Peet contributed positively to the Fund's annual performance. Being overweight Westfield Corporation detracted from relative performance in conjunction with the Fund's underweight positions in Dexus and Mirvac Group.

Antares Investment Returns
Performance to 30 June 2017[1]

		6 mths %	1 yr %	3 yrs % p.a.	5 yrs % p.a.	10 yrs % p.a.	Since Inception % p.a.
Australian Equities							
Australian Shares Fund Inception date: 28/02/1987	Net return[2]	1.6	15.9	5.7	10.5	3.3	8.6
	Gross Return[3]	2.6	18.1	7.8	12.7	5.4	10.5
	Benchmark Return	3.2	14.1	6.6	11.8	3.6	8.7
	Net Excess Return	**-1.6**	**1.8**	**-0.9**	**-1.3**	**-0.3**	**-0.1**
	Gross Excess Return	**-0.6**	**4.0**	**1.2**	**0.9**	**1.8**	**1.8**
Elite Opportunities Shares Fund * Inception date: 29/11/2002	Net return[2]	4.1	16.0	7.5	11.5	4.9	10.3
	Gross Return[3]	4.9	17.6	9.1	13.1	6.4	11.9
	Benchmark Return	3.2	14.1	6.6	11.8	3.6	9.0
	Net Excess Return	**0.9**	**1.9**	**0.9**	**-0.3**	**1.3**	**1.3**
	Gross Excess Return	**1.7**	**3.5**	**2.5**	**1.3**	**2.8**	**2.9**
High Growth Shares Fund * Inception date: 02/12/1999	Net return[2]	3.9	16.0	7.9	11.9	4.9	10.1
	Gross Return[3]	4.9	18.3	10.0	14.1	7.1	12.5
	Benchmark Return	3.2	14.1	6.6	11.8	3.6	8.1
	Net Excess Return	**0.7**	**1.9**	**1.3**	**0.1**	**1.3**	**2.0**
	Gross Excess Return	**1.7**	**4.2**	**3.4**	**2.3**	**3.5**	**4.4**
Listed Property							
Listed Property Fund * Inception date: 20/01/1998	Net return[2]	-3.3	-7.8	9.8	11.8	0.3	6.5
	Gross Return[3]	-2.4	-6.0	12.0	14.0	2.3	8.6
	Benchmark Return	-3.7	-6.3	12.0	14.1	0.1	6.8
	Net Excess Return	**0.4**	**-1.5**	**-2.2**	**-2.3**	**0.2**	**-0.3**
	Gross Excess Return	**1.3**	**0.3**	**0.0**	**-0.1**	**2.2**	**1.8**

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.

*Closed to new Personal Choice investments.

Notes

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