



K2 International Equity Update Quarterly Report - 31 March 2017

Market Review

Global equity markets started 2017 without skipping a beat. Despite a few hiccups late in the quarter, investor optimism persisted with any dips disappearing faster than a pick-pocket on the Champs-Élysées.

Trump's Healthcare bill remains stuck in the "pits" much like Daniel Ricciardo at Albert Park. As politicians and engineers alike work feverishly to make it to the starting grid, the world still waits for details on proposed US tax reform and infrastructure spending plans. We can safely assume that the Republican Party currently resembles the same level of productivity and co-operation as a French farmer.

US equities proved resilient in Q1 2017. Like Seabiscuit versus War Admiral in their famous 1938 match race, the tech heavy Nasdaq (+8.9%) showed a clean pair of hooves to the large cap S&P 500 Index (+4.7%). US 10-year treasuries closed the quarter at 2.39%, slipping 5 bps as the Fed raised rates 25 bps and conditioned the market for a further two increases in 2017.

Major European bourses benefitted from the rising tide of euphoria sweeping across the Atlantic as all European indices advanced led by the Spanish IBEX return of +10.2%. UK's FTSE 100 added +2.0%, the French CAC moved +4.6% higher and Germany's DAX rallied +6.3%. Mainland Europe is showing improved PMI indicators, a pick-up in construction activity and a consumer that is slowly dusting off the cobwebs.

After lagging the initial post-Trump election rally in November and December, Asian markets made up for lost ground in Q1. Hong Kong rallied 8.9% as strong corporate earnings buoyed investors in a market that was already cheap relative to global peers. This was supported by its big brother China, with the H-Share index increasing +8.6%. Chinese linked markets Korea and Taiwan both benefited from the goodwill climbing +5.7% and +5.8% respectively. India advanced +12.0% while Australia was the laggard of the bunch, staggering higher by a mere +2.3%. Japan declined a modest -0.4% (TOPIX) as the Yen increased by +7.9% vs the USD.

Asian markets generally benefited from Asian banks' linkages to higher US interest rates as they access off-shore funding, while the improved corporate news flow excited investors. A stabilising Chinese property market combined with a range of tightening measures announced by Beijing to clamp down on rampant speculation also settled investor nerves. The oil price (WTI) retreated -5.8% to \$50.59 as concerns mount over increasing US stockpiles and the impending wall of shale. The AUD closed March at 76.29 US cents, up +5.8% for the quarter.

Outlook

Equity market headlines have been preoccupied with the latest musings from President Trump (and in a shameless plug for one of our biggest positions, apparently he tweets from an iPhone!). The reality in markets, however, has been rather different. They are not pricing faster growth or inflation with US inflation expectations falling. In fact, the US 5Y5Y (nominal 5y bond minus 5y US inflation-linked bonds) forward breakeven has now moved back near 2%, similar to levels seen immediately following the US presidential election.

Expectations of further interest rate rises in the US have firmed with continuous hawkish rhetoric from the Federal Reserve underpinning a minimum of two more rate rises in 2017 on top of the 25bps increase in March. Now that markets are firmly entrenched in a tightening rate cycle, we are skeptical of the ability for bond proxies to continue their post-GFC re-rating and thus are actively avoiding or shorting assets that fall into this arena, including property, infrastructure related assets, yield plays with no underlying growth and expensive consumer staples. Excluding these assets, we still see numerous opportunities within the US market. These include banks who are significant beneficiaries of rising rates, economically sensitive cyclicals that had been forgotten since the GFC and structural growth plays including leading technology names.

In Europe, the positive fundamental backdrop has played second fiddle to elections and the rise of the far right and "so called" eventual destruction of the European Union. So far the black-swan events have not materialized as the Dutch elections didn't live up to the far right expectations while Marine Le Pen is losing momentum in the French Presidential race.



Currency

The Fund maintains a net equity market exposure of ~82%. We have reduced our AUD hedging from 96% to 75% and increased our Euro and JPY positions to 10% and 6% respectively. Our rationale is as follows:

- Recent positive economic growth surprises in Japan and Europe from a low base indicate a stronger rate of change in economic improvement compared to the United States.
- Europe's recent political elections are indicating the political status quo is likely to hold in the medium term.
- Investor expectations embedded in European equities or the Euro are not overly optimistic versus US equities or the USD.
- The Republican Party's inability to pass their own legislation has raised uncertainty regarding Trump's reform agenda.
- Even if agreement is reached on US infrastructure upgrades, time lags of 1.5-2 years before project commencements are likely.
- While global growth is becoming more synchronized which is net positive for the commodity price environment, some of this good news is already discounted in the prices of resource companies and commodity based currencies such as the AUD.
- Australian economic growth is looking patchy at best and the policy responses and reform initiatives to maintain the extended upside are looking decidedly underwhelming.
- Australia's last trade number was somewhat disappointing, although the trend should remain positive.
- Actions by the Australian banking sector to raise interest rates on housing loans will help alleviate the necessity of the RBA to raise official cash interest rates in the short term.

Portfolio Insight: Royal Caribbean Cruises

It is said that cruising brings out the best in people! There is a lot to love – exotic locations, all-you-can-eat buffets, pampering, waterparks, great restaurants, meeting new people, the list goes on. Offering great value for money, people of all ages are embracing the cruise lifestyle in abundance. We expect this trend to continue.

Founded in 1968, Royal Caribbean Cruises is the world's second largest cruise line operator with a fleet of approximately 40 ships. The cruise industry is currently enjoying a surge in popularity driven by strong mass market consumer demand and manageable supply growth. These favourable industry dynamics should persist as cruise penetration rates continue to grow.

China is the wildcard and cruising meets the requirements of the majority of Chinese holiday makers. In addition to the benefits mentioned above, cruising provides the unique combination of being suitable for large groups in addition to the availability of on-board shopping and gambling opportunities. Starting from a low base and helped by increased supply and distribution channels, Chinese growth is a key catalyst for future multiple expansion.

Advancements in technology improve the booking process and enhance the on-board user experience further increasing net passenger yields and company profitability.

Despite a soft consumer spending environment, the shift in philosophy of acquiring experiences rather than things supports an expanding industry demand. For example, there are 33% more millennials (25 – 40 year olds) taking cruises today than there were 2 years ago. A rising tide lifts all boats!

Royal Caribbean offers an attractive risk/reward profile, underpinned by a non-demanding FY17 forecast PE of 14.1x and supported by a strong EPS growth profile of 17% p.a. over the next 3 years.