AUDUCO

Q2 FY20 STATUS REPORT

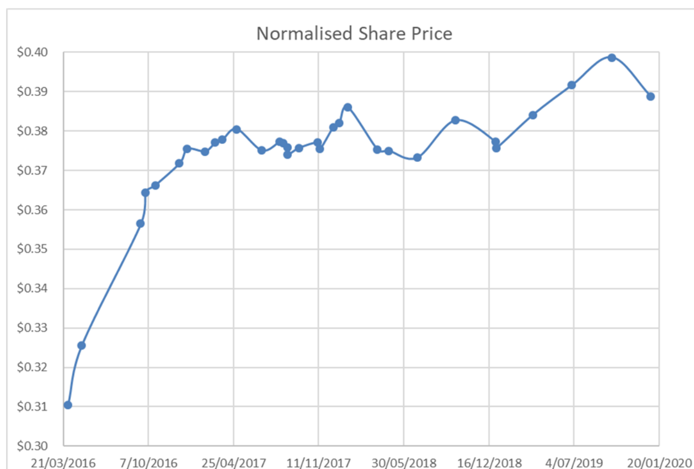
"Our focus, trust" *"Accounting for every trade"*

Investment Performance of Deployed Capital

Auduco Pty Ltd's current investment position and normalised share price are summarised in the table and figure below.

31/12/19 Snapshot		
Top 4 Equity Holdings	**Ave Entry Price**	**Market Price**
ANZ	$23.43	$24.63 (2Q perf: -$3.90)
BOQ	$10.44	$7.25 (2Q perf: -$2.67)
NAB	$25.69	$24.63 (2Q perf: -$5.07)
	Current Market Value	

Note 1: Does not include interest currently being accrued in term deposit accounts.



Amid global stock market euphoria, that we did not think possible, Australian shares unperformed. In fact, banking shares were the notable underperformers. We included the price performance of our key holdings in the quarterly snapshot table above. These drops have mostly occurred during the last month of the quarter. BOQ has not been at these price levels since the 2011 Flash Crash. ANZ, and NAB, being 'big 4', have held up better.

The Banking Royal Commission has been a sentiment catalyst for the share price pressure this year. However, the recent Westpac money laundering scandal is what amplified the recent moves

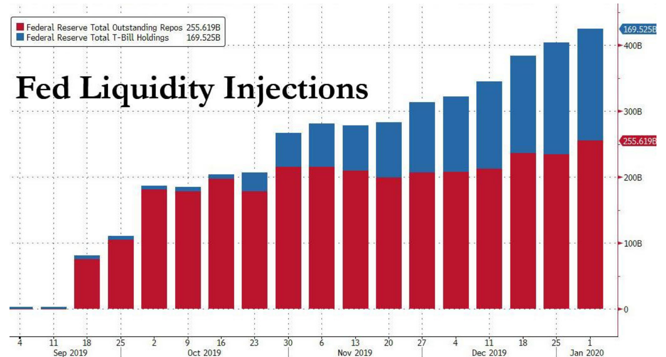
Fundamentally, quite some time ago, we presented predictions that Australian banks would undergo margin pressure and that their dividends would also come under pressure. This is coming to pass, with banks reducing dividends; ANZ couple of years ago, BOQ this calendar year, NAB this quarter. It is occurring for different reasons than our prediction, instead of higher international lending rates (which have been suppressed thanks to another drastic round of central bank stimulus), it has been lower RBA rates that has led to the margin pressure.

Nonetheless, this is the reason for our relatively light positioning. We expect further pricing pressure and aim to take up more shares at prices that reflect good dividend yield at a sustainable payout level.

Some shorts were attempted, per last quarter. These were again stopped out.

Synopsis

US stock markets have once again gone 'parabolic' as they did leading into January 2018. And it was all down to the Fed. A massive bond repurchasing program was introduced to quell sudden spiking funding rates. They also issued new bonds, as per their actions during QE, but stated that it "was in no way QE". Comical….especially given these emergency injections have occurred with record low official unemployment rates and stock indices at all time highs.



The result of "not-QE" was a strong surge in asset prices at a critical technical juncture which blew a large, potentially bearish setup that we were tracking, out of the water. There has been only one down week since that point. It was the only week where purchases went negative.

So, 2019 was the year of the Fed. In fact, this era (2019-2019) has been about central banks with a consensus that goes something like:

- Central banks can print a lot more money.
- Stocks rise when central banks print more money (though historically, there has always been a point where this fails).

Centuries old economic principles do not seem to factor anymore. Sales and profits no longer matter. Many Wall Street experts are touting that manufacturing (which is contracting globally) also no longer matters, despite it representing a large chunk of the US GDP (~$2.1 trillion). It is all down to the Fed and their printing press. Furthermore, they appear to be watching markets, as shown in the Q4 FY19 update, as the interventions have come as the markets hit critical technical support. If this sounds like a complaint, in part, it is. Free market price discovery is currently non-existent, and this is frustrating for those (like us) who are seeking value based on long proven natural economics. This is a temporary situation, albeit an extended kind of temporary, as these factors will weigh at some point. But, the fed (and, to some extent, Donald Trump) have proven they can keep it going.

Apologies for the lack of gains. We have approached this from the point of view of 'not blowing your money' – yes, capital preservation first. Hence, our conservatism. Had our shorts worked out, the potential contribution to the capital pool could have grown by as much as $40,000. Unfortunately, we lucked out.

It is hardly a comfort that we are not the only ones who find the environment difficult. For example, only 11% of large cap active funds beat their benchmarks for the decade.[1] Also within the S&P 500, the percentage of stocks that outperformed the benchmark for the decade was a low 32% (synonymous with the concentrated performance we have highlighted in previous updates). This means that most of the index gains are concentrated in a few components and, fund managers, are consequently achieving smaller returns by following their traditional diversification-based allocation models.

The macro situation remains the same as in previous updates. It is actually becoming more exacerbated. There was no earnings growth in US stocks in 2019. It was all multiple expansion to even higher levels. Here is a comparison:

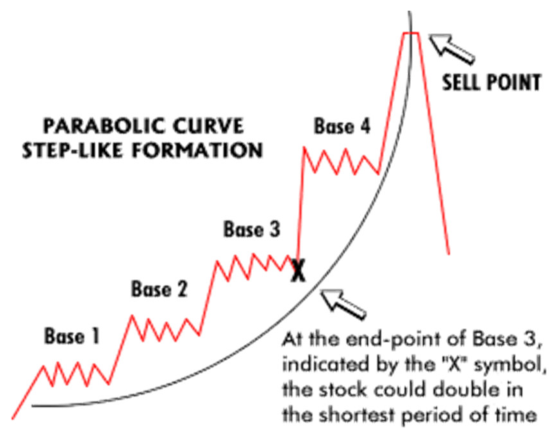
- In 2018:
  - The US Fed hiked 100 bps, global EPS grew 8% and global equities fell 11%.
- In 2019:
  - He US Fed (was forced to) cut 75 bps, EPS grew 1% and equities rose 20%.

Here is a visual in S&P 500 terms.

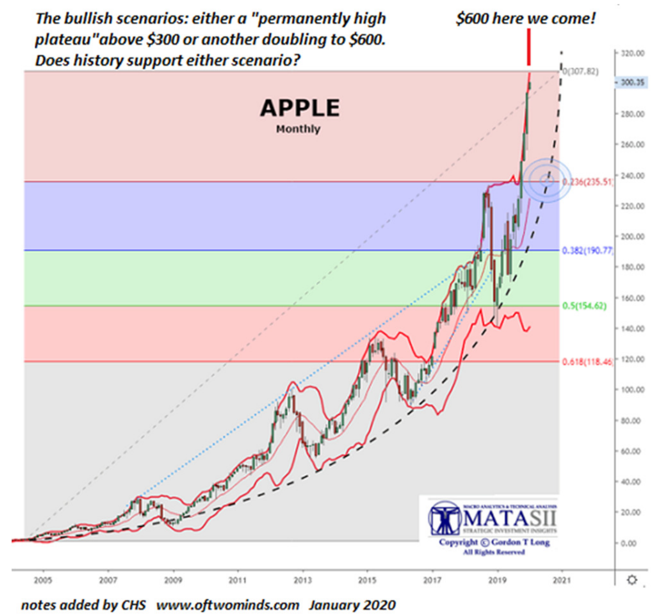
This present period is similar to 1999-2000. However, the profit gap is now the widest in history. However, it can keep going. At the time of writing the Nasdaq is 36% above its 200 day moving average. In 2000 it was 150% above, which is difficult to grasp. But it shows this can keep going. How long? We don't know. As implied before, we believed a sustained correction was on the cards for 2019. Whilst the macro factors and banking sector performance reflects a correction, market indices are not acting in concert, as they historically have.

So, the Nasdaq has gone parabolic again, like it did in early 2018 The S&P 500 has also, but less so. The difference is it has occurred after what was technically an almost 2-year consolidation. Whilst the market is "more expensive than ever" (the total market capitalisation to GDP ratio is the highest it has ever been – so is the price to sales ratio when measured relative to the S&P 500), it now technically looks like it can run further. The Australian market has also recently (at time of writing) broken out into new highs, this time from a reasonably sound base. So, we are now looking to add positions, still sparingly (as there remains a dearth of blue chip value), and with a view to cut them rapidly in the event of a deleterious turn in the markets.

To highlight the danger, below is an image of a typical parabolic pattern. Parabolic moves end when the confidence that the parabolic move can't end becomes the consensus. Nobody believes this could be 'The Top' because the confidence that every future ascent can be front-run is so high.



Here is a long term chart of Apple.



Its market capitalisation is currently almost the same as Australia's GDP!

Whilst it looks dangerous, of note during the recent Nasdaq rally is that not all of the usual other mega tech stocks have contributed to the gains equally. Amazon has barely participated. This could either be bearish or it could "grow legs". The Fed's bond buying program is not expected to cease until April this year. This suggests that market indices like the Nasdaq going up beyond all reason and stocks like Amazon can turn into a major contributor, even if Apple's price starts collapsing.

Interesting fact from Hoisington Asset Management: Each additional dollar of total nonfinancial debt outstanding over the first 2 quarters of calendar 2019 generated 40 cents of GDP in the USA. This is 25% lower than 20 years ago. This is not a prediction. Its just another symptom of what we have been observing. Plus, it serves as a reminder that not much changes for us in the absence of value offerings with decent yields. We need to be patient and tread carefully until it eventuates.

For more information contact Dr Gianluca Paglia, 0425 388 222

[1] According to Bank of America