Walden Financial Planning

Investment Solutions

Spring 2018

Welcome

In this edition of Investment Solutions magazine we take a look at what's next for Australia resources.

BT Financial Group Investment Specialist, Riccardo Briganti, provides us with a market update on local and international markets.

Finally, we share insights on how you can invest in the environment.

Until next time – happy reading.

Walden Financial Planning
Drew Walden
07 4032 3655
info@waldenfinancialplanning.com.au
www.waldenfinancialplanning.com.au

https://www.facebook.com/Walden-Financial-Planning-232877403555216/?eid=ARAtRkNxn8j7C1clglCydz54Ou5l
pU-jqyqk7LoluY-zZxaFn0zNJlP1AYMps6Jd1pgTwrrOF_o4gMuc

Market update

The leadership challenge against Malcolm Turnbull and the subsequent elevation of Scott Morrison to the position of Prime Minister dominated the headlines in August.

However, its impact on financial markets was largely confined to the Australian dollar which fell against most other currencies as investors focused on the policy uncertainty brought about by political instability. While there was a slight recovery following the resolution of the challenge, the dollar has not returned to previous levels.

Equities markets were more concerned with the August reporting season with listed companies announcing their profit results and providing guidance on their prospects for the period ahead. While the reported profit results were largely in line with expectations, there were some significant share price falls where companies disappointed. For example, Flight Centre, Origin Energy and Ansell all suffered double digit price declines in August.

In economic news, Australia's gross domestic product (GDP) and inflation figures were released. The Australian economy grew by 0.9% in the June quarter following a 1.1% increase in the previous quarter. As a result, the economy has grown by 3.4% over the past four quarters. Household private consumption expenditure increased 0.7% to be 3.0% above year ago levels. While the result is relatively strong, spending has been partly financed by a fall in the household saving ratio to 1%, suggesting it may not be sustained. This is the lowest saving rate since 2007 and compares to the 8%-plus saving rate seen in recent years.

Inflation figures were also released earlier in the quarter. A 0.4% increase in consumer prices in the quarter means that inflation is now running at 2.1%. While this puts inflation inside the Reserve Bank's (RBA) 2-3% target range, there is little to suggest the RBA is concerned about the inflation trajectory or that the probability of a domestic rate hike has increased. This partly reflects that other inflation measures that arguably provide a better measure of underlying inflation trends remain below the target range. Furthermore, wages growth remains relatively subdued at around 2.0%.

US economic data remains relatively robust with US GDP growing at an annualised rate of 4.2% in the June quarter following a 2.2% result in the first quarter. This has reinforced expectations the US Federal Reserve (the Fed) will increase the fed funds rate by another 25 basis points at its September meeting. This would take the fed funds rate to 2.0-2.25%, still below the long-term average of around 3.25%.

At the same time, the US Core Private Consumption Expenditure Price Index, which is the Fed's preferred measure of inflation, increased by 1.9% compared to a year ago providing some comfort that inflation pressures are not overly problematic. In contrast, the standard consumer price index showed a 2.9% year-on-year increase in July, in large part due to higher oil prices. Nevertheless, wage and inflation momentum in the US suggests that further gradual tightening of US monetary policy is likely into 2019.

What's next for Australian resources?

It's buoyant times in the Australian resources industry, with recent data from the government's official forecaster, the Department of Industry, Innovation and Science (DIIS) highlighting the importance of commodities for the economy.

As global economic growth remains robust, DIIS estimates that Australia's commodity export earnings will lift from a record high of $226 billion in 2017–18 to $238 billion by 2018–19[1].

While the nation's bulk commodities, iron ore, coking (steel-making, or metallurgical) coal and thermal (electricity) coal doing most of the heavy lifting, after $200 billion worth of investment, it's liquefied natural gas (LNG) that's stepping up to join them[2].

DIIS expects that by 2022-23, LNG will have risen by 70% to $39 billion, overtaking coking coal to become the second biggest commodities earner after iron ore[3]. However, exports of gold and base metals, in particular, copper, are forecast to grow more modestly over the same period.

Resilient commodity prices are expected to earn more than $1 trillion for the nation over the next four years, says DIIS[4] – a figure that is equivalent to almost 60% of gross domestic product (GDP).

The nation's commodities bounty is also underscored by the rise of newer minerals, as sectors such as electric vehicles, battery technologies and renewable energy create a demand for lithium, cobalt, graphite, vanadium and nickel. Of which, Australia has the reserves, and the industry capability, to be a major player in world markets for these commodities.

Australia retains status as the world's largest iron ore exporter

Major iron ore miners are set to retain Australia's status as the world's largest iron ore exporter with Australia's iron ore export volumes forecast to increase from 846 million tonnes in 2017–18, to 887 million tonnes in 2019-20[5]. This increase is driven by the ramp-up in production by the largest producers[6].

BHP is moving towards its goal of producing 290 million tonnes a year and has projected that its iron ore production will be between 273 million tonnes and 283 million tonnes in the 2019 financial year[7]. BHP has commenced its US$3.6 billion ($4.9 billion) South Flank iron ore project in the Pilbara region of Western Australia, a mine that the company predicts will be the biggest it has ever built in terms of annual production. With an estimated production of 80 million tonnes of iron ore a year, this would replace production from the ageing Yandi mine.

Rio Tinto says it's on track to hit the upper end of its 2018 guidance for iron ore shipments from the Pilbara (330 –340 million tonnes), after shipments in the June quarter surged 14% on the same period last year[8]. Rio Tinto is soon expected to add to its West Angeles and Robe Valley developments by approving its US$2.2 billion ($3 billion) Koodaideri iron ore mine. Koodaideri would support the production of Rio Tinto's high-grade Pilbara Blend lump product. With both Pilbara Blend and BHP's Newman lump grades benefiting from China's crackdown on the environmental impact of its steel production industry. This is due to the high quality of the products allowing the steel mills to retain productivity and cost efficiency while conforming to the anti-pollution measures.

Buoyant indications in the niche areas of the Australian commodity roll-call

The nation's leading mineral sands miner, Iluka Resources, which produces zircon and titanium dioxide ores, reported a 21% surge in revenue in the June 2018 half-year on the back of higher prices for its products[9]. Rare earths miner, Lynas Corporation (Lynas), is making good on its potential to become a major producer to China of rare earths oxides and neodymium and praseodymium (NdPr), and an alternative source of these commodities. Lynas mines the ore at Mt. Weld in Western Australia and separates it at its processing facility in Malaysia. According to Melbourne investment firm, Newgate Capital, Lynas is estimated to produce about 24% of the world's NdPr, and is the only major producer outside China[10].

Similar market drivers are also changing the game for established nickel producers, such as Western Areas, which is now tweaking their businesses to produce nickel compounds which go straight to batteries. These newer metals with high-tech exciting markets are adding to the earnings and export potential – and confidence – of Australia's resources industry.

1. Resources and Energy Quarterly, June 2018, p. ii
2. Australia and the Global LNG Market
3. Resources and Energy Quarterly, March 2018, p. 54
4. Resources and Energy Quarterly, March 2018, p. 1
5. Resources and Energy Quarterly, June 2018, p. 25
6. Resources and Energy Quarterly, June 2018, p. 21
7. BHP Operational Review for the Year Ended 30 June 2018
8. Rio Tinto second quarter operations review
9. Quarterly Review 30 June 2018, Iluka Resources
10. Newgate Absolute Return Fund research note October 2017.

How you can invest in the environment

Finite resources, and the need to consider the impact of the climate in fulfilling needs from water, food and energy supply, has opened opportunities for companies to offer alternative or sustainable solutions.

Investing based on climate or environmental concerns is a growing space, and typically factored in the broader sphere of sustainable investments.

Environmental and climate concerns

According to a report by the United Nations, global water demand is expected to increase by nearly one-third by 2050[1]. Alongside this, the global population is tipped to be 9.8 billion people, all needing food, shelter and water, to be supplied from the restricted resources of earth[2].

The challenges of supply and efficient use of the resources we have requires different ways of thinking and alternative approaches to how we use and manage the resources available to us. In theory, investing in this area could cover any activity to mitigate the impact of climate and human damage; works to prevent that impact, substitutes for things considered to cause or magnify environmental damage and promote more sustainable and efficient use of our resources.

The environmental and climate theme incorporates everything from renewable and alternative energy sources, energy efficiency, "smart" power grids, recycling, biofuels, water purification technology, anti-pollution technology, environmental remediation and rehabilitation, new materials (particularly for batteries) and "carbon trading" markets (more specifically, "right-to-emit-carbon-dioxide" trading markets.)

Finding investments in this area

On the Australian Stock Exchange (**ASX**), the most prominent stocks to claim climate credentials are the alternative energy suppliers. Of these, the purest-play exposure is Infigen Energy (**IFN**), which owns and operates six wind farms and one solar farm in Australia, with a total operating capacity of 557 megawatts (**MW**). It sells this electricity, and also sells large-scale generation certificates (**LGCs**) that it receives for generating "eligible" renewable electricity – it sells these LGCs to electricity retailers, who, as "liable entities" under the Renewable Energy Target (**RET**) scheme, are obligated to buy an LGC for every MWhr of "ineligible" (that is, fossil-fuel-derived) electricity they buy.

Major Australian energy suppliers AGL Energy (**AGL**) and Origin Energy (**ORG**) are also renewable energy generators, but within broader portfolios that at this stage include fossil fuels. Currently only 10% of ORG's energy generation is renewable, but it wants to triple that by 2020, with goals to produce 1200 megawatts from wind, solar and hydro. AGL has 9% of its generation coming from renewables at present (coal provides 84%), but has committed to exiting its coal-fired generation by 2048, and replace it by a mix of improved efficiency, renewables and demand response.

New Zealand renewable energy providers Mercury NZ (**MCY**), Meridian Energy (**MEZ**) and Tilt Renewables (**TLT**) are also listed on the ASX: MCY and MEZ are both profitable dividend-payers. MCY operates nine hydro stations, five geothermal power stations and a multi-unit gas-fired power station; MEZ operates seven hydro stations and ten wind farms in New Zealand and Australia. TLT has three operating wind farms in New Zealand and four in Australia, with a pipeline of wind and solar farms in development in both countries. These are companies to watch, as the renewable energy market develops in our region.

Taking a fund-based approach

For investors concerned about the risks involved in investing in single companies, accessing sustainable investments through managed funds and exchange-traded funds (**ETFs**) can provide an alternative.

At BT Financial Group (**BTFG**), we refer to these as "sustainability themed investments", which encompass any managed investment that takes into account environmental considerations, governance standards (how a company is run) and social factors (such as product safety or labour standards) in their approach. These are known as environmental, social and governance (**ESG**) factors.

Sustainability themed investments can also involve a negative screen where it excludes certain industries or sectors due to concerns about ethical, environmental or social issues or positive screens where particular sectors or issues are targeted for inclusion, for example focusing purely on renewable energy companies. In some cases, sustainable investments may use a combination of ESG factors, positive and negative screens as part of investing decisions.

Although social and corporate-governance factors might not interest an investor motivated more by environmental or climate concerns, using a sustainable investment strategy may help identify the types of investments such an investor would wish to support.

Investing through ETFs in this space is still a growing area, the US offer a number of climate specific ETFs which may provide an indication of how the Australian market could develop in the future. Some examples include the iShares Global Clean Tech ETF (Nasdaq; **ICLN**), the Change Finance U.S. Large Cap Fossil Fuel Free ETF (NYSE Arca; **CHGX**), the First Trust Global Wind Energy ETF (NYSE Arca; **FAN**), the Guggenheim Solar ETF (NYSE; **TAN**: it is the only pure-play US solar ETF), PowerShares WilderHill Clean Energy ETF (NYSE Arca; **PBW**) or the First Trust NASDAQ Clean Edge Green Energy Fund (Nasdaq; **QCLN**). There are even specialist yieldco ETFs.

Climate and environmental investing is an interesting and growing sphere, but as always, investors should be careful to ensure any selected investments match with their overall investment strategy and goals.

1. The United Nations World Water Development Report 2018 – Nature-based solution for water
2. United Nations, World population projected to reach 9.8 billion in 2050, and 11.2 billion in 2100, 21 June 2017.

Walden Financial Planning P 07 4032 3655 W www.waldenfinancialplanning.com.au