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K2 International Equity Update
Quarterly Report - 30 June 2017

Market Review

The K2 Select International Absolute Return Fund gained 0.6% for the quarter and 15.5% for the financial year ended 30 June 2017. Since inception in December 2004 the Fund has delivered 10.6% p.a..

Yogi Berra, the famous NY Yankee, was many years before his time when, obviously referring to ETFs, he suggested that “Nobody goes there anymore. It’s too crowded.” As ETF proliferation and flows reach a saturation point, this wall of capital buying everything in the index both good and bad has the potential to significantly distort markets. The jury is still out on how this story ends…

For oil markets, it feels like “déjà vu all over again,” down -9.0% in Q2 to USD46.04 (WTI), in a repeat of early 2016 as fundamentals are dismissed and sentiment takes over. This is good news for US motorists, however, who paid an average of USD2.21 per gallon for gasoline over the 4th July weekend, the lowest price in 12 years.

Gas wasn't the only liquid guzzled in the US to celebrate independence. We met with global spirit company Campari in June and apparently Americans like to buy their Sky Vodka in 1.75L bottles!

On the political front, European elections took centre stage. France provided us with some welcome relief as Emmanuel and Brigitte Macron moved into the Elysee Palace bringing much needed stability to the region and delivering significant blows to the aspirations of the far right and left in the process. As we go to print the UK government is still somewhat in limbo. The young millennials voted with their feet, making a mockery of Theresa May’s best laid plans of an expected increased majority. With Brexit negotiations underway, the job of UK Prime Minister is somewhat of a poison chalice for at least the next 18 months, implying little change to the status quo.

As we round out the quarter central banks globally adopted a more hawkish tone. We especially admire Chairperson Yellen’s confidence, proclaiming “we will not have a new financial crisis in our lifetime.” This is reminiscent of the Titanic crewman who proudly claimed that “Not even God himself could sink this ship.”

US equities demonstrated their steely resolve in Q2. Despite a late quarter hiccup the tech heavy Nasdaq rallied +3.9% overshadowing the large cap S&P 500 Index return of +2.6%. US 10-year treasuries closed the quarter at 2.30%, slipping 9 bps as the Fed raised rates +25bps in a move that was widely anticipated.

Despite mixed political results the major European indices were largely unchanged over the quarter. UK’s FTSE 100 fell -0.1%, the French CAC was flat and Germany’s DAX inched higher by +0.1%.

Asian markets were generally stronger in Q2. Following a strong performance in Q1, Hong Kong advanced a further +6.9% as strong corporate earnings underpinned investor confidence. Big brother China was more subdued (-0.9%) despite positive news late in the quarter of impending inclusion in the MSCI global indices. Korea (+10.7%) led the way benefitting from their tech exposures. Australia was the laggard of the bunch, with the ASX 300 declining by -2.4%. Japan increased +6.6% (TOPIX) as the Yen fell by a modest -0.9% vs the USD.

The AUD closed June at 76.89 US cents, up +0.8% for the quarter.

Outlook

The June quarter can best be characterised by global equity markets enjoying an extended period of excessively low volatility. The VIX index, a measure of 30-day implied S&P 500 Index option volatility, hovers at record lows of around 10%. In the short term we harbour growing concerns that investors have become a bit too complacent and whether this is the calm before the storm.

Valuations, without underlying earnings growth, are like an elastic band. Once they reach a point of maximum tension they either break or more than likely snap back. In a low interest rate environment, where returns are scarce, justification exists for chasing growth at any price. However, recent hawkish rhetoric from central banks makes it clear that rates are rising and sooner rather than later. This will put further pressure on already stretched valuations as discount rates rise.

On the flip side, financials are a significant beneficiary of rising rates and when combined with buyback support and increased dividends we are comfortable raising our exposure to that part of the market.

In Europe, with elections out of the way, investors can re-focus on the relatively positive economic outlook for the region albeit off a very low base. We continue to selectively add European domiciled names to the portfolio although, similar to the US, value is becoming harder to find.

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Reflective of a more subdued outlook for global equities, the Fund progressively reduced net exposure during the June quarter. Long exposure was reduced from 86.5% in March 2017 to 53.3%. In addition the Fund's short exposure rose from 4.2% in March 2017 to 5.9%. Accordingly, the Fund's net exposure is 47.4%; 34.9% lower than 3 months ago.

We have reduced our AUD hedging to 2.0% and increased our EUR and JPY positions to 16.4% and 6.7% respectively as we see pressure on the AUD coming through from rising global rates and housing related stress on the financial sector of the domestic economy.

Portfolio Insight: Corning

For over 160 years, the US listed Corning has specialised in the development of glass, ceramics and optical physics products for the consumer electronics, telecommunications, automotive and life science industries. The way we interact with technology is via a screen, whether to view, touch or both. Best known for their Gorilla Glass used in smart phones and tablets, Corning's unique market leading position ensures the company is well placed to benefit as the Glass Age evolves. A strong balance sheet, including $3bn of precious metals used in component construction, and significant free cash flow generation enables substantial returns to shareholders. Future upside includes the introduction of glass backing on smart phones effectively doubling content per device and use in mass market cars. Corning offers an attractive risk/reward profile, underpinned by a non-demanding FY17 forecast PE of 17.4x.