THE ENCYCLICAL DECEMBER QUARTER 2017

To Our Unit Holders

Our Funds' Performance to 31 December 2017

	3 Month %	1 Year %	3 Year % p.a.	5 Year % p.a.	Since Inception p.a.
EGG Small Companies Fund	+13.05%	+16.68%	+15.12%	+11.71%	+11.74%
S&P/ASX Small Ordinaries Accumulation Index	+13.69%	+20.02%	+14.38%	+7.39%	+6.67%
Outperformance	***-0.64%***	***-3.33%***	***+0.74%***	***+4.32%***	***+5.07%***

* Fund returns are calculated post fees.

	3 Month %	6 Month %	1 Year % p.a.	5 Year % p.a.	Since Inception p.a.
EGG Emerging Companies Fund	+14.28%	+27.68%			+38.24%
S&P/ASX Small Ordinaries Accumulation Index	+13.69%	+18.70%			+23.71%
Outperformance	***+0.59%***	***+8.98%***			***+14.53%***

* Fund returns are calculated post fees.

For the quarter ending 31 December 2017, the Eley Griffiths Group Small Companies Fund returned +13.05%, the Eley Griffiths Group Emerging Companies Fund returned +14.28%, compared to a +13.69% move in the Small Ordinaries Accumulation Index (XSOAI).

Market Review & Strategy

Animal spirits in the December quarter took their cue from the prior quarter close. Stocks rallied from the opening bell and extended their advance through yearend, paced by strong moves across the small resources sector. Lithium, energy and several gold names blazed the trail. Info Tech and financial services stocks did the heavy lifting for the small industrials group. Not surprisingly, small caps widened their performance lead over the top 100.

2018 concluded with a December quarter surge in corporate transactions. Among the big caps, **Westfield** agreed to a tie up with European REIT monolith, Unibail-Rodamco, and Royal Dutch Shell quit its $3.4bn stake in **Woodside Petroleum**.

At the small end a flurry of deals kept interest in small and emerging companies at elevated levels. Accor bid $1.8bn for **Mantra Group**, **Cleanaway** bid for **Tox Free** and **Macquarie Bank** sold its 11.5% holding in tollway operator, **MQA**. Oracle had a tilt at **Aconex**, 'Boardriders' (parties associated with Oaktree Capital) bid for **Billabong**, who in turn bid for Surfstitch. **AWE** received acquisition proposals from Chinese group, CERCG, as well as **Mineral resources**. Several other transactions were on foot at the time of writing this note.

In previous *Encyclical's,* Eley Griffiths Group have applauded (and supported) well reasoned primary and secondary transactions. **Wagners** and **Netwealth** were fourth quarter examples of successful new floats with appealing fundamentals. During calendar 2017, 100 companies IPO'ed with an average performance of +55% from debut to end December. 42 were underwater and 17 doubled from issue price. Such levels of activity underscore the confidence both corporates and professional investors have in stocks at the present time.

Continuing the trend evident in September quarter, insider sell-downs also featured during the period. Attracting most attention were partial sales from executives at **Monadelphous, Mineral resources** (before bidding for AWE), **Corporate Travel**, **Bapcor**, **Wisetech** and **RCR**.

As is often the case, the AGM season provided a volatile window for investors as companies provided operations updates for the period post mid year results. **Steadfast** and **Monadelphous** satisfied investors whereas, **Nufarm, G8**, **Monash** and **Webjet** fell short of consensus expectations, in so doing provoking a bilious response from investors in some cases.

It would be reasonable to recognise two pockets of euphoria that have ballooned in the market over the past 12 months. Infant nutrient producers tapping the great China opportunity (**BUB'**s, **Bellamy's**, **Wattle Health**, **Aumake** and **A2 Milk**) have attracted rapacious market interest as have a number of aspiring lithium producers (**Pilbara**, **Kidman** and **Altura**) looking to tap into the Lithium market and the emergent EV industry. The lithium space now speaks for ~ 4.4% of the Small Ordinaries Index (very close to the current weight of the gold sector).

Technical Summary

The Commodity complex diverged in performance through December quarter with base metals pausing and beginning a consolidation phase ahead of their next leg higher.

Aluminium's rally from December 2015 finally drew breath whilst **Copper**'s advance, of similar duration, began its congestion between \$2.90-\$3.20. The bear market break in copper is indisputable and its unfolding range-bound price action marks a classic mid-cycle pause ahead of a run to higher levels.

Nickel is less clear cut and remains trapped in a defined downtrend. The market needs to see price action above \$5.85/lb before the bear case can be cancelled. **Gold** continues to grind forward, posting higher lows but needing to clear US\$1364 before we have a proper bull-drive on our hands.

Crude continues its climb, clearing WTI resistance at \$61.50 which was an important milestone. A move through this level puts the 'black-gold' in the mid \$70's/bbl.

Softs remain the commodity laggards. The grains continue to flatline, as does cotton, coffee and cocoa.

The **Australian dollar** is working nicely to the technical script with support from the 0.6811 low in early 2016 holding as required in December. The unit should grind higher from here.

The **EURUSD** cross has broken from its 2 ½ year base and is poised to test important resistance at 1.25. To be watched. Meanwhile, the **US Dollar Index** (DXY) continues its year-long retreat from a weekly key reversal day in January 2017. The downtrend requires a close above 94.30 (90.12 at the time of writing) before the DXY can rally.

September quarter's *Encyclical* detailed the very bullish prognosis for global equities markets. Seasonals support the buy case through to the end of May.

Andrew McCauley of Veritas Securities points out that the DJIA recently posted its 70th record high for the year. He confirms that this is the greatest number of highs ever in a given year. 69 recorded in 1995 and 56 in 1987. Interesting to note the melt-up occurring in the Dow Transportation Index of late. Dow theorists, few on the ground these days, would rejoice in this set up (Charles Dow's 1902 work calls for price action confirmation between the Transport and Industrials indices before the markets primary trend can be reliably divined).

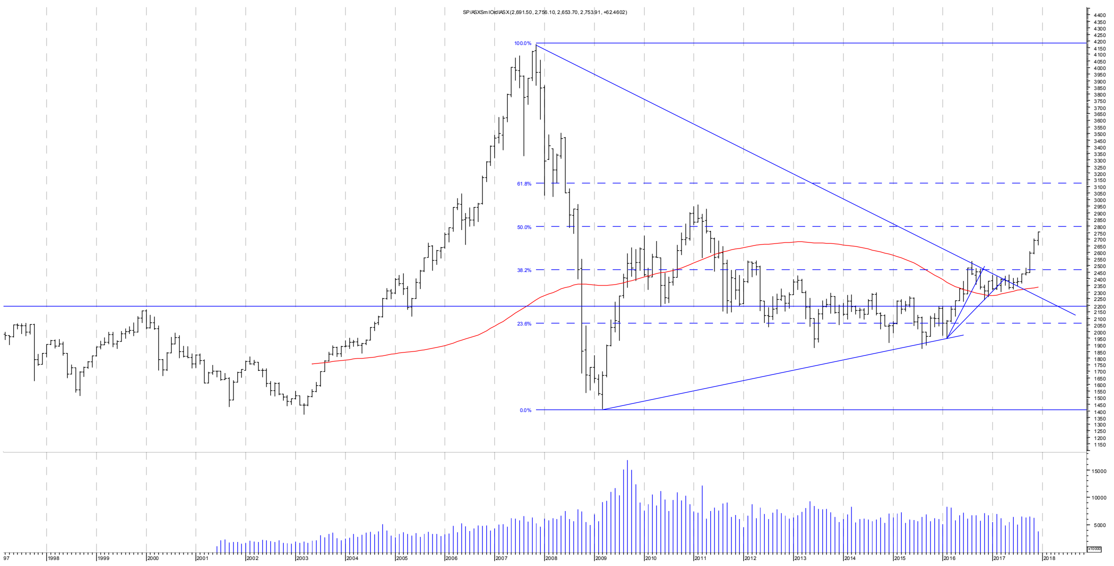
When markets begin to trade into unchartered waters, as the US is presently doing, it is often instructive to use Fibonacci ratios to project natural levels of resistance/support (simply, I have used prescribed multiples of the S&P 500's 909 point move from Oct 2007-March 2009). For the S&P 500 future resistance levels to be noted are: <u>2833, 2940 and 3290.</u> Read: Stay long the US market.

Locally, the **ASX200** has finally cleared 6000, a move that required heavy lifting from our resource majors and support from the banks and Telstra too. The move to 6150 and back to support is entirely predictable and BULLISH. Witness the break-return-consolidate-rally action in the Dow Jones between July-November 2016 ie the period presaging the current bull-drive.The ASX200 should advance to 6390 before readying for a move to the old high at 6800.

Of greater interest to Eley Griffiths Group is the constructive price action unfolding in the small and emerging companies segment. The Small Ordinaries Index (**XSO**) has outpaced the **ASX100** for much of this calendar year (XSOAI +20.0% v XTOAI + 11.1%).

Momentum in smalls remains strong, supported by improving market breadth too. The number of stocks in the index trading above their 100 day moving average now tallies 70% versus 66% in November and 53% at September end. Small resource names have propelled the small ordinaries upward and for CY17 are +24.7% vs industrial names +10.3%. This feels like it will continue.

The below chart illustrates the XSO rally and the significant break to downtrend.

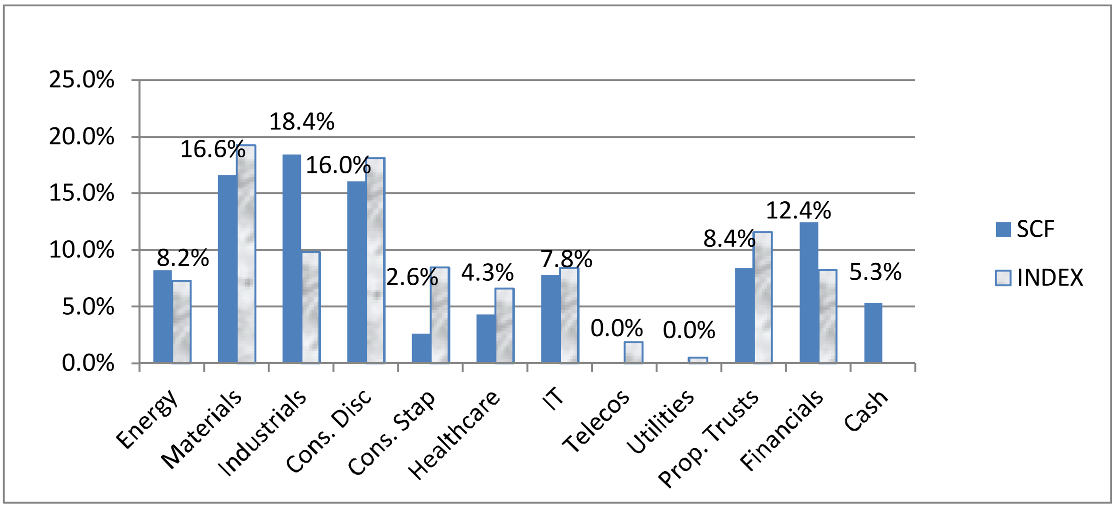


The Mid Cap 50 benchmark (**XMD**) has enjoyed strong investor support since mid 2012, propelling it to 20 year highs (note: ‘The 20 Year’ club is light on local membership).

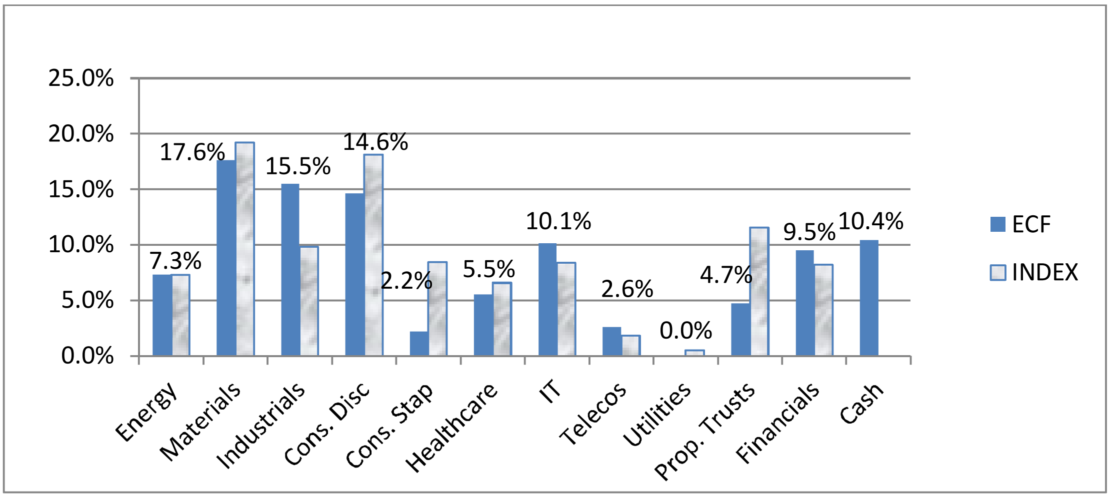
The below relative strength chart of the XSO versus the XMD points to the possibility of a revival of small caps v mid cap stocks, fuelled by professional investors repositioning or rotating market cap horizons for the markets likely next leg of outperformance. Reading the chart, the downward price plot reflects mid cap out performance, upward action is small caps outperforming.

The Portfolio

The Small Companies Fund was positioned as below:



…and the Emerging Companies fund:



During the December quarter, our Small Companies Fund (SCF) enjoyed the strong debut and early stock purchases from **Netwealth** (+36.6%) and rallies from **MMA Offshore** (+27.3%) and litigation funder **IMF Bentham** (+23.8%). Our positions in **GEM** (-23.1%), **Collins Foods** (-9.9%) and **Monadelphous** (-7.2%) detracted from performance. In the Emerging Companies Fund (ECF), positions in **Wagners** (+39.5%), **AWE** (+34.1%) and **Boom Logistics** (+30%) provided a strong updraft. **Noni B** (-11.6%), **Base** (-9.2%) and **Mastermyne** (-9%) dragged on the portfolio.

SCF Top 5 Stocks	ECF Top 5 Stocks
ARB Corporation Limited	Afterpay Touch Group Ltd
Cleanaway Waste Mgt Ltd	Emeco Holdings Limited
Saracen Mineral Holdings Ltd	Lifestyle Communities Limited
Smartgroup Corporation Ltd	NRW Holdings Limited
WorleyParsons Limited	Wagners Holding Company Ltd

One or both funds hold the following stocks and may have been active in them during the December period.

Your manager continues to like the unfolding prospects for **Sims Metal**. New management were installed in August with a clear mandate to invest in technology and complementary assets to better position the group to improving economic conditions (and scrap generation) in North America and beyond. Scrap prices remain firm and the absence of China from international markets is contributing to supply-side tightness. Schnitzer's preliminary Q1 result confirmed the buoyant scrap market at present. Sims should also be a beneficiary of US tax changes too.

Emeco controls Australia's largest heavy equipment rental fleet and is slowly emerging from the conflation of the GFC and mining slump. Management are working to a strategy of de-levering the balance sheet, optimising fleet utilisation and carefully bolting on compatible businesses to better position the group to improving industry demand. Equipment supply has tightened and prices for new /used gear have risen sharply, placing the Emeco business in a strong competitive position.

A modest allocation was secured in the IPO of Queensland construction materials group, **Wagners.** The groups strong exposure to Queensland and Federal Government infrastructure programmes appealed to us, as did managements strike-rate in project delivery and growing order book. The group is actively developing several new generation construction materials that provides some earnings optionality in the medium-long term. On an FY18 EV/EBITDA of ~10x the stock was not especially cheap but its earnings outlook is positive.

BT Investment Management was sold from the portfolio during the period in review following a FY17 result that fell just shy of expectations. Fixed cost growth of ~10.7% was a surprise to us with management advising they expected fixed costs to increase by 13-15% in FY18, largely MIFID/regulation related. Your manager has been alert to slowing flow momentum in Jo Hambros and the flow picture for the UK business is not certain at this time.

Outlook

A vigorous rally into the first week of January exhausted itself, ushering in a retracement back to 6000 in the ASX200. This is disappointing given the very firm price action in the US market. Bulls will regard the pull back as a healthy return move, bears a failed break.

Whichever your flavour, experience has conditioned us to be patient when markets test critical levels. Early January trade has historically been volatile on seasonally reduced volumes, but it is encouraging to see individual stock sell-offs being aggressively bought back in past days. Witness the performance of QBE post its profit warning.

The local market continues to respond to the broadening global rebound and this appears likely to be sustained. PMI readings are close to 6 mo highs in the US, Europe and China.

The thoughts of a consensus trade playing out (long resources/mining services/heavy cyclicals) are beginning to niggle, as our mid 2016 portfolio positioning becomes a little too crowded these days. For now this positioning will continue to work.

This manager is keeping vigil over the near term trajectories of the US dollar, the US10Y and when investor psyche begins interpreting good news as bad. Nothing to see here right now.

Valuations for equities are fulsome (but not excessive), attractive relative to bonds (equity risk premiums remain pro-equities) and reflect investor confidence in earnings outlooks across major markets.

The February reporting season will test investor resolve with recent resource quarterlies (and commodity prices) suggesting that the sector is cum upgrade. Pre season earnings confessions among industrial names have largely been contained.

Eley Griffiths Group Ratings

Zenith February 2017	**Recommended** 2nd Highest Rating	**Lonsec** February 2017	**Recommended** 2nd Highest Rating
		http://eleygriffiths.com.au/news-reports/	