Important Reminders

Reminder One

This monitor is designed to be a reliable source of data and a provider of insights to capital qualified wholesale investors. The Corporations Act is the reliable source of such qualification. The subset of wholesale investors who will benefit most from this monitor are those that have twice the qualifying level of investable capital for sophisticated investor status or hold professional investor status.

Reminder Two

In the 27th July 2017 edition, we concluded what we believed there would be the only three events important enough to trigger the next edition of this irregular Monitor. These events were:

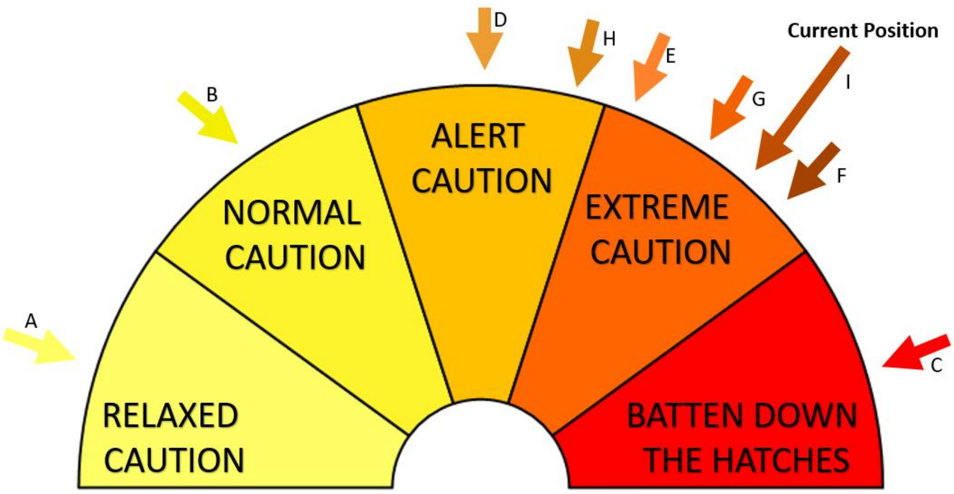
a) Another significant legislative tax event like the change to superannuation regulations commencing from 1st July 2017.
b) An ominous shift in the Baillie Financial Repository Caution Meter.
c) A change in the Australian/US official interest rates relativity of plus or minus 0.5%.

We made an exemption to the above on 1st November 2017 because of the unsuspected Federal Open Markets Committees decision not to increase the US Interest rate range in late September, and its impact on the cost of interest on over 30% of the Australian Bank liabilities.

The US unlike Australia has a range for its official overnight interest rate and now we have experienced c) above. In fact, the increase in the US overnight interest rate is not only 0.75% more than the position at 27th July 2017, the premium offered by US interest rates is the highest since the Float of the Australian Dollar in December of 1983.

In addition to c) being triggered b) has been triggered as well. The present position of our Caution Meter is ‘extreme caution’:

Financial Repository Caution Meter



For reasons that should become evident in this monitor, we postponed presenting the Monitor until we were aware of the US interest rate position at the September 2018 FOMC meeting.

Reminder Three

Capital Stability is determined by marginal taxation rates, inflation and interest rates.

Capital Stable instruments must not leave you exposed to a permanent loss of capital if they are to be true to their name.

We use the RBA preferred measure of inflation which is currently 2.1% on a trailing annual basis. The impact of tax on the real return from 1st July 2018 is.

Tax and Medicare Rate	Nil	15%	19%	27.5%	34.5%	39%	47%
Minimum Before-Tax Return required to prevent a permanent loss of capital	**2.1%**	**2.5%**	**2.6%**	**2.9%**	**3.2%**	**3.4%**	**4.0%**

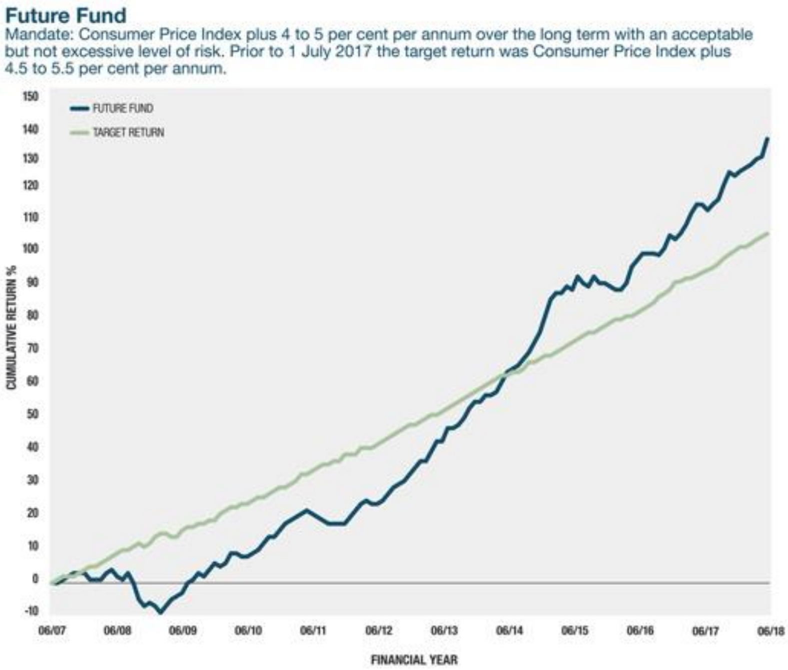
Reminder Four

The nominated benchmark that Baillie advises the wholesale investor cohort to use is the Future Fund.

A useful cross reference to the validity of Baillie's benchmark choice is to review the asset allocation of the 2 very large Canadian superannuation Funds with the Future Fund. The one that is servicing defined benefits identical to the intent of the Future Fund is 3 times larger than the Future Fund. The Ontario Teacher's Fund that is a benefit target provider is about the same size as Australia's Future Fund.

The 2018 annual report of the Future Fund has not been made available but the financial metrics for the 2018 financial year for the Future Fund was 9.8% for the year ending 30 June.

The graph below of the performance of the Future Fund versus targeted returns shows that timing of investments can be extremely significant, contrary to the advocacy of many of the self-appointed experts from the rank of financial professionals.



Future Fund asset allocation

The asset allocation of the Future Fund 30 June 2018 is shown below:

Table 2: Future Fund asset allocation at 30 June 2018		
Asset class	**$m**	**% of Fund**
Australian equities	9,753	6.7
Global equities		
Developed markets	26,500	18.2
Emerging markets	10,609	7.3
Private equity	20,607	14.1
Property	9,366	6.4
Infrastructure & Timberland	11,728	8.0
Debt securities	12,934	8.9
Alternative assets	22,390	15.4
Cash	21,950	15.1
TOTAL	**145,837**	**100.0**

The above is why understanding the capital stable mechanisms preventing you from having to expose your capital to a permanent loss of capital is so empowering and rewarding.

The reward is that you can and should be especially selective in your investment decisions. The empowerment is the contentment that this is both affordable and advisable.

Current Circumstances

Normally, we avoid any reference to geopolitical issues and the expected short-term and mid-term economic impacts of these issues.

We have achieved this in past by limiting our Monitor to the same 3 questions. The need for the exception in this monitor is the US led/ China Trade War and the flow on impact to the crushing of the exchange rates of the emerging economies. In turn this elevates the service cost and maturity burden of developing countries debt that is US denominated.

Whilst Baillie is Australian- Centric we have always understood that the international wholesale debt market provides over 30% of the liabilities that our banks need to fund their assets.

The hue and cry over interest rate rises by all but the National bank in the last few weeks had to be expected. Three interest rate rises of the federal reserve overnight interest rate range in 2018 ensured that this had to be the case.

Deliberately Baillie has developed two capital stable Fund's that are variable interest rate based, and two that are fixed rate based. One of the fixed rate variants has a one-year tenure and the other up to a seven-year tenure.

The 3 questions to be re-addressed

Question 1. What are those you can trust up to?

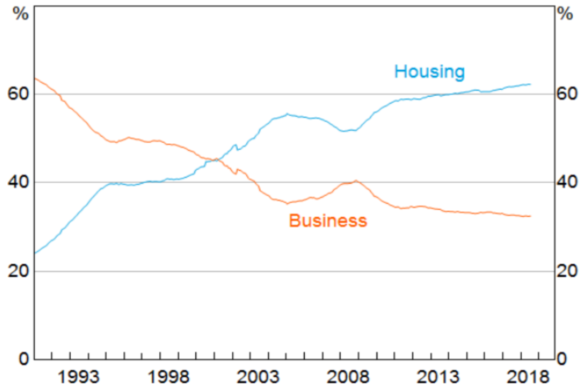
a. RBA

The RBA has kept our overnight cash rates at 1.5% for 26 months and for the last 12 months has categorised that the 1.5% rate as accommodating economic growth.

This is shorthand for the RBA is expecting that the next move in interest rates will be up though down is not totally dismissed.

The bank which heads our Financial Stability Council, had its Assistant Governor, Financial System, Michelle Bullock speak on the Evolution of Household Sector Debt Risks just recently. Given this is the largest criticism of our economy the RBA views are the most important.

Graph 3
Banks' Domestic Credit
Share of total



Sources: APRA; RBA

We consider Graph 3 reprinted above to be extremely insightful that our high levels of comparable household debt, both historically and relative to other economies should not cause us to lose sleep at night.

The disinflation over the last twenty-five years and the ADI Bank's ability to constantly protect their margins has limited the downside dampener of high household debt on economic growth without necessarily igniting a contraction.

b. APRA

Commentary arising from the Royal Commission into Australian Banks have tabled a probably valid proposition that Bank misbehaviour could have been avoided if APRA had been more pro-active. In Hyman Minsky parlance, the work of APRA has certainly reversed the trend of increasing speculative and Ponzi debt, to more Hedge debt at the expense of Speculative debt in particular. This is a critical reversal of trend.

The last five years has seen liquid ratios introduced to stop anyone feeling the need to rush to the bank to withdraw funds, only to put the cash under the mattress. Tenor balances on the maturity of the borrowers is in advance of tenor maturities of the banks funding sources.

The above was topped up by limiting the growth of the loan arena where Speculative and Ponzi debt would have been expected to be most prevalent i.e. interest only debt for highly leveraged residential investors.

c. ASIC

Westpac's most recent $35 million fine for breaches of the National Consumer Credit code for breaches representing 10% of all loans written in a specific period is a small bite out of Westpac's profits.

Its value is that this fine plus all others doled out by ASIC has put all the banks on notice that the "blind eye" period is over.

The charging of the ANZ's treasurer by the Commonwealth Department of Public Prosecution as part of the ANZ's Capital raising activity in 2015 will motivate a level of transparency, governance and clarity not seen since deregulation was triggered in 1983.

Question 2. Is the US on solid financial footing?

The US was extremely finically volatile post GFC, and on the high seas until the trough of residential property prices was reached in 2011.

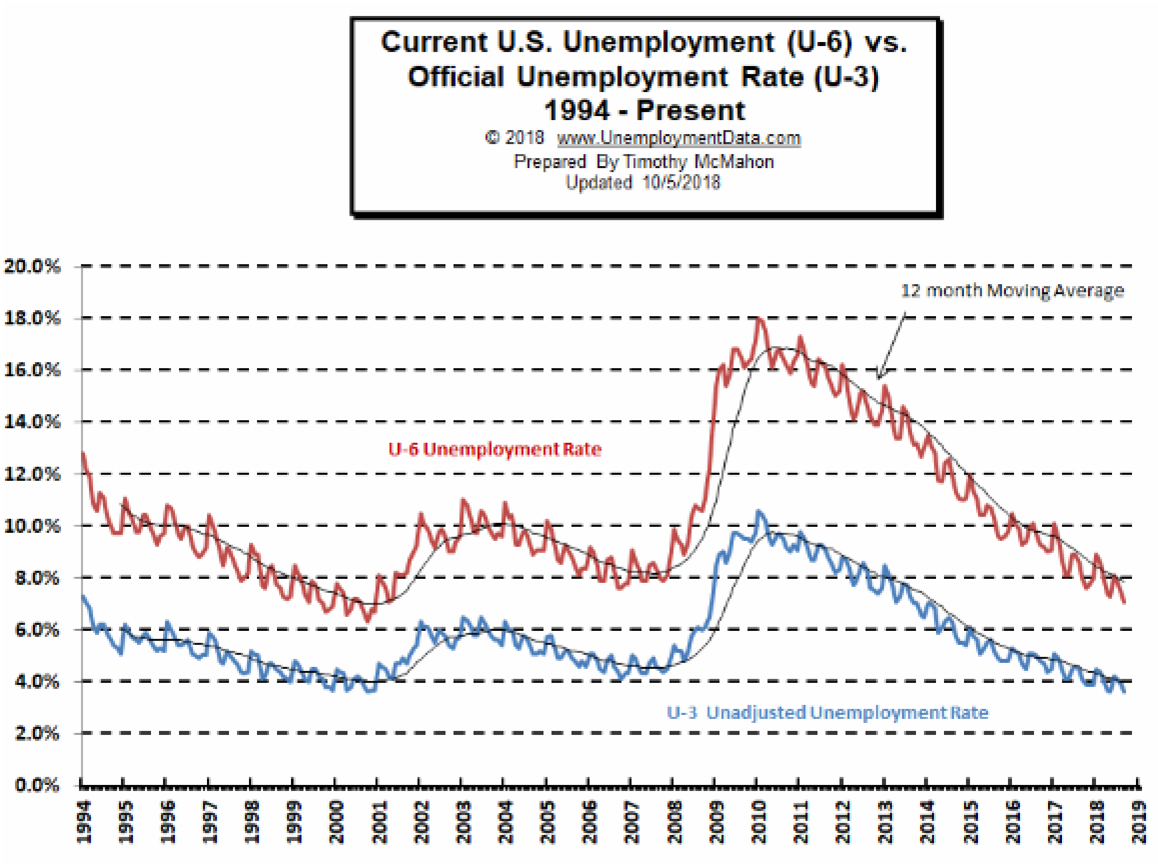
Following that, the vulnerability was related to zero interest rate policy of keeping the overnight cash rate to nil and the reserve rate to 0.25%. Combined with consequences of previous and ongoing Quantitively Easing, monetary policy was in experimental conditions or unmapped territory.

We have detailed in earlier monitors that we prefer U6 as the measure of unemployment as our proxy for inflation trending in the United States. In particular, we are interested in the ratio of U3 to U6.

US-driven Geopolitical issues that impact us

Save for walking out of the Paris accord, blowing up the NAFTA treaty, demanding higher contributions from NATO nations, building a wall on the Mexico border and triggering a trade war with China, the US had well and truly reached Terra Firma.

This is best seen by the relative numbers of U3 and U6 where the tipping point of U6 being less than 100% of U3 has been achieved but only to be reversed in September. However, the geopolitical issues highlighted, and the debt blow out of emerging economies puts us in unchartered waters. This has caused us to move Baillie's caution meter from 'Alert Caution' back to 'Extreme Caution'.



FOMC Orientation

Economic projections of Federal Reserve Board members and Federal Bank presidents under their individual assessments of projects appropriate monetary policy, September 2018.

	Median				
Variable	**2018**	**2019**	**2020**	**2021**	**Longer Run**
Change in real GDP	3.1	2.5	2.0	1.8	1.8
June projection	2.8	2.4	2.0	n.a.	1.8
Unemployment rate	3.7	3.5	3.5	3.7	4.5
June projection	3.6	3.5	3.5	n.a.	4.5
PCE inflation	2.1	2.1	2.1	2.1	2.0
June projection	2.1	2.1	2.1	n.a.	2.0
Core PCE inflation	2.0	2.1	2.1	2.1	
June projection	2.0	2.1	2.1	n.a.	
Memo Projected Appropiate Policy Path					
Federal funds rate	2.4	3.1	3.4	3.4	3.0
June projection	2.4	3.1	3.4	n.a.	2.9

Question 3. What have those we can’t trust been up to since the last monitor?

It was not accidental that we nominated some years ago that the most untrustworthy that impact your capital stability are the banks. By extension we presumed that “shadow banking”, Insurance, and wealth management were appropriately “tarred with the same brush”.

Given the vast coverage of the Royal Commission we can’t add value to this question so will review and reassess this in the future.

Where to from here?

The fall in the unemployment rate (U3) from 6.5% to 6% for Afro-Americans could be an important portent of the future. Pork barrelling is not sustainable, so the tax cuts and the infrastructure spend in the US buys time, but we don't need the trend to fear from greed to go too far.

The US categorization that interest rates are no longer "Accommodating" seems contradictory to the stated intention to continue to raise interest rates. Related to this much has been written about at what level of increased Bond yields will lead to an exit from equities.

We have no idea but recognize the best defence is having surplus cash flow, not only to cover desired costs of living, but also the extra-ordinaries like a house deposit and equity so grandchildren are ensured of never exposing themselves to unprofitable debt.

Ensuring that you never have to sell price sensitive assets is further backup, and why there is a permanent place for Capital Stable assets in your Portfolio.

Please contact a Baillie Asset Management Ltd analyst to find out how we can help in this regard.

Appendix 1 - Financial Repository Caution Meter

Alert State	Description
Relaxed Caution	Baillie's standard debt policies apply (Principal & Interest capacity over 5 years). No need to be too granular on sustainability or robustness of earnings.
Normal Caution	Be cautious before any new investment and apply higher investment risk premier rules for the choice of investments in ownership of business investments over capital stable repositories.
Alert Caution	Ignore positive news, focus on negative news.
Extreme Caution	Only invest in business where compelling reasons about durability, duration and low price of earnings apply. Increase risk premier hurdle for loans to business and housing of business investment categories.
Batten Down the Hatches	No new investments, liquidate were no permanent loss of capital is experienced, were temporary is a possibility.

Position	Time	Reason for Movement
A	1992	Starting point, the completion of the last Australian recession.
A to B	05/04	1. Bill Evans warning on unsustainability of housing activities. 2. Anecdotal evidence from clients that lines of credit secured on unearned equity on homes was being used for consumption.
B to C	12/07	Impacts of the Global Financial Crisis hit Australia, Centro refinancing debacle. An unpredictable event that involved massive fraud and poor regulation in the United States financial system.
C to D	07/09	Restoration of confidence in Australian bank hybrids.
D to E	10/14	US Federal Reserve completes the tapering of Quantitative Easing (QE3).
E to F	10/15	Continuing negative data on underemployment and nil/negative equity in the US housing system.
F to G	03/16	President of the European Central Bank, Mario Draghi declares $60 billion Euros a month of quantitative easing, signalling a separation from the US.
G to H	06/17	Chair of the Federal Reserve Janet Yellen states she doesn't expect another GFC in her lifetime. All 34 banks tested passed the federal reserve's stress test, first time in seven years.
H to I	03/18	Geopolitical reasons, mainly US led trade wars.