JCP Investment Partners – Market Outlook 2016

January 2016

2015 was a mixed year for global equity markets with the MSCI World Index finishing down -2.74%. Despite a strong rebound in the December quarter (+5.5%), the Australian equity market finished the year down -2.13% (ASX 200). The best performing sector was Utilities, gaining 17.4%, whilst the worst performing sector was Energy, falling 30.3%, in line with the weaker oil price (WTI -31% and Brent -45%). It was a similar story in the US, with the Dow (-2.23%) posting its first negative year since 2008, whilst the S&P 500 fell -0.73% after three straight years of double digit gains. It was a better story in Europe, with European shares posting an average gain of +6.9% for 2015. France's CAC gained +8.5%, and Germany's DAX advanced +9.5%. Without the benefits of the ECB's stimulus, the UK's FTSE 100 closed -4.9% lower. In Asia, China was extremely volatile, but finished stronger (+9.4%), as was Japan (+9.3%).

We expect markets to grind higher in 2016, delivering a total return of +1.8% (with a risk of +/-11.8% around this forecast) for the Australian equity market, and an expectation that Australian equities will most likely continue to under-perform global equities. This relatively low growth expectation reflects our view that the Australian market overall is currently fairly valued and we expect conditions to be less favourable as the US continues to normalise interest rates.

An ongoing challenge for markets in 2016 will be excessively low inflation globally, plus the first ongoing rising rate cycle in the US in over a decade. Whilst the Fed has recently lifted rates, we will not have to worry about monetary policy becoming tight for some time and there are no serious economic imbalances that warn of an early recession, as such, we expect markets should be able to record modest gains in the year ahead. Additionally, we believe that the continued accommodative policies globally will lead to inflationary pressures at some point in the future.

United States: the end of zero interest rate policy

The US economy is heading into 2016 with a large number of questions at hand. The questions are broad and are well understood, but unfortunately it doesn't help that we are now in the unknown territory of a post zero interest rate policy environment. We are at the so-called middle of the experiment, however this time around we face a more fundamental proposition: is the US economy strong enough to generate nominal growth in revenues? Is it strong enough to proceed with interest rate rises? (at least as fast as the market expects); and in turn, what will be the impact on global demand?

At JCP, we believe that the US continues to be important to the economic and equity market outlook in Australia because the trajectory of US interest rates largely determines the interest rate cycles for most other economies, especially small, open, foreign capital dependent economies, such as Australia.

We have long held the view that the Fed would tighten only when it is sure that the economy is on a sound footing. As such, equities should not be hampered by the start of the rising rate cycle; at least, not until they get to a restrictive level (which is likely to be a year or two away). Equities will be in greater trouble if the Fed is not able to raise rates further over the next couple of years, as that would suggest the economy has not recovered, having bearish implications for earnings.

Post the recent rate increase and associated commentary by the Fed, we have taken comfort in our positive view on the US and continue to favour US economic exposure in the portfolios. The economy is tracking along well and the labour market continues to show positive signs, however the unemployment rate might need to over shoot on the downside to result in further wage inflation, (although pockets of wage inflation have already been seen in parts of the economy, such as the housing trade).

The chart below illustrates the expected trajectory of US rates according to the Fed (who expect rates to be closer to 3.25% by 2018), versus closer to 2% implied by the market. At JCP, it has been our long-held view that the Fed will raise rates later than the market expects, and that the pace of subsequent hikes will be more measured (ultimately leading to higher inflation in the future). Looking at the yellow line it becomes apparent that the market now fully discounts the slow rise in rates, implying that our view is incorporated in the market's view. In fact, our portfolio positioning would actually benefit from US rates being higher than the market is implying, given the AUD would fall, and the Australian economy would be under far more pressure from higher US rates than US based companies.

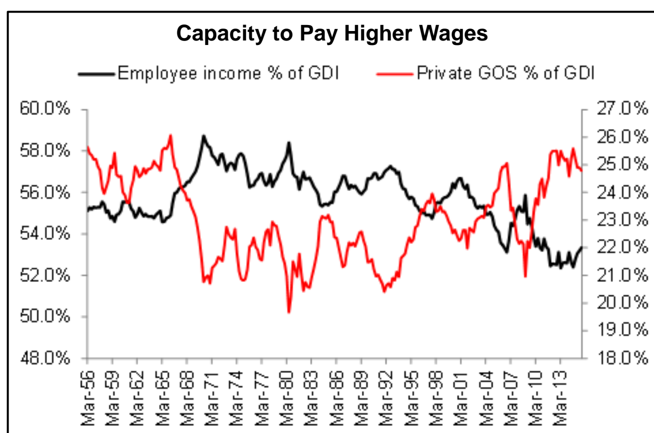
Source: BOAML

The backdrop to the Fed's decision is that the Consumer sector is positive, with employment in a steady uptrend and wage growth likely to strengthen modestly as the labour market tightens, which is consistent with our recent feedback from a number of US homebuilders.

The biggest disappointment however remains the lack of measured wage growth, especially in relation to unemployment levels and business pay expectations. Wages growth is now arguably the most important signal for the Fed, with several indicators suggesting that wages will accelerate in 2016, e.g.: a recent survey by NFIB suggests close to 20% of companies in the US plan to increase compensation in the year ahead.

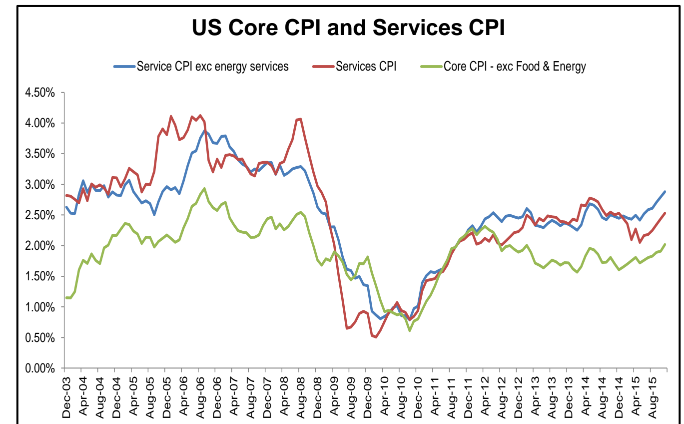
Source: Minack Advisors

To the degree to which wages and profits share are mean reverting there is evidence of a capacity to pay higher wages, and for companies to earn less (see chart below: note that GOS refers to Gross Operating Surplus – a proxy for company profits). If this process assists rate normalisation or creates better opportunities for investment, US exposures will be assisted vis-à-vis Australian-based equity.



Source: BEA, BLS, NBER

We continue to monitor US wages growth, and services inflation for signs of resilience, and signs that financial repression is creating the wealth transfer away from savers. Looking at inflation, the signs are promising. The base effects of the second round of energy price declines (as an input) in core CPI begin to dissipate in 2016. The headline rate will also have some breathing space. In services inflation (the engine of wages growth), price growth is higher than any period over the past 7 years, while in Services CPI (exc. energy services), which represents 58% of the basket, the annualised 6 month growth rate is above 3%.



Source: JCP Investment Partners

Can the US economy afford normalisation of interest rates? Time will tell, but having price inflation and positive trends in wages is the first step.

If conditions were to deteriorate in the US, arguably monetary policy has largely achieved all it can in terms of boosting growth. In the event of a new downturn, the response would need to be massive fiscal stimulus. In the US in 2014, real government infrastructure spending in net terms (i.e. after depreciation) hit the lowest level since 1950, meaning the US could justify spending money upgrading basic infrastructures such as roads, bridges, airports and sewers.

If this economic weakness were to occur in the midst of another global debt crises, we would expect much of the fiscal expansion to be funded by printed money from the US Federal Reserve.

We continue to favour companies leveraged to the US economy, supported by our view that the underlying economy is moving in the right direction.

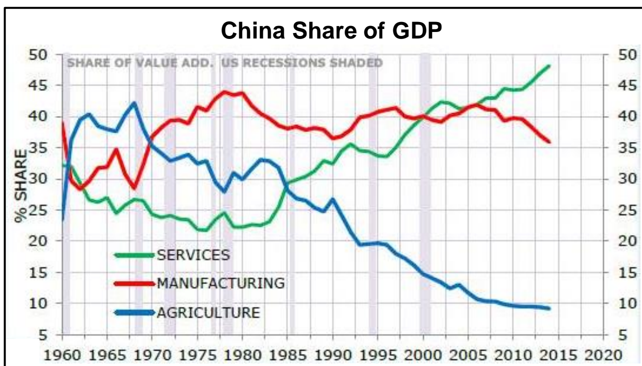
China: Need to manage their capital and credit conditions

At JCP, we think about China from two perspectives: (1) China as a whole; and (2) the impact of China on the Australian economy.

For **China as a whole**, 2016 will be a pivotal year, but not on the production side, as China is no longer a GDP growth story. In fact, GDP will continue to slow. The official data will continue to be massaged, (China's 13th 5-year plan, which has been approved, contains a medium-term growth target of 6.5% or above). We expect alternative data points will most likely point to an even softer growth outcome.

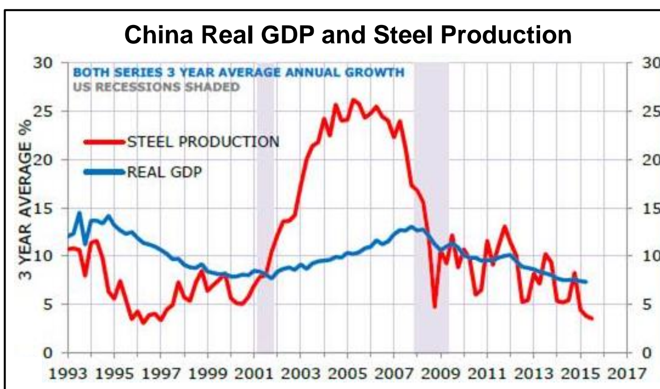
China's two-speed economy is expected to continue. The manufacturing sector continues to experience sharp declines across a broad range of indicators. There is deflation in the Industrial sector and that has put downward pressure on profits and capital spending. The government has emphasised new supply measures to address over capacity, which are positive, although the key constraints of unemployment and foreclosures need to be addressed. The construction sector also is in decline, as previous excesses are worked off.

The service-oriented sectors are faring much better. The transition toward consumption and services and away from exports and capital spending is to be welcomed and will play out over many years. But it was never going to be easy, and deflation in the Industrial sector will have knock on effects on employment and thus growth in services spending.



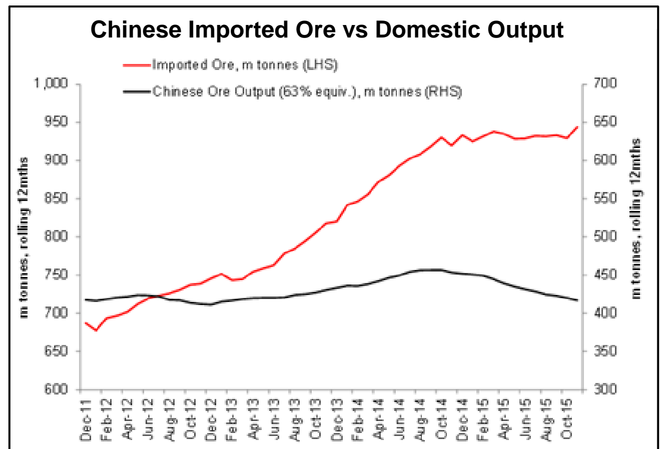
Source: Minack Advisors

In regards to **China's impact on Australia's economy**; Chinese steel production will continue to fall; the critical issue for the iron price will be the degree of retrenchment of domestic ore mining.



Source: Minack Advisors

Over the past year the weakness in ore demand has been met by declines in domestic production (-8% yoy), allowing imports to remain constant (see following chart).



Source: JCP Investment Partners, NBS, Citi

As shown in the chart above, the signs are promising but Chinese domestic production of iron ore will need to continue to fall if increased supply from sources such as Roy Hill is to find a buyer.

The persistence of the Australian produced oversupply sees our forecast for iron ore prices continuing at current levels for the remainder of 2016 (USD$40), and bottoming in 2017 (USD$37.5). The extended period of low prices should force higher cost production to be permanently removed, allowing prices to rise toward our long run price of USD$48.

The strategy to maintain portfolio exposure in resource companies on the lower end of the cost curve with strong balance sheets continues to be a key area of focus, especially in a climate of forced capital raisings and asset divestments.

The Chinese domestic economy will continue to rebalance, innovation will continue to emerge, and subject to changes in supply arrangements, Chinese consumers will continue to demand recreation and sustenance from Australian providers.

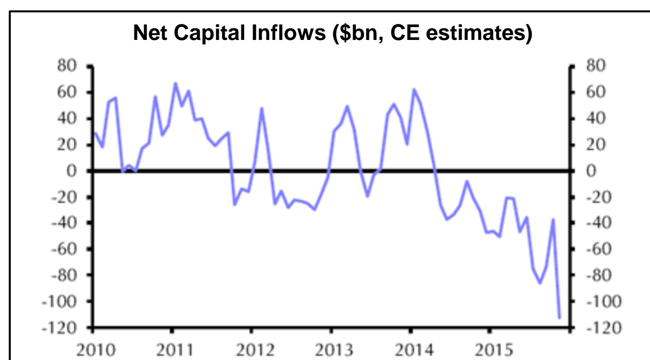
We anticipate that China's ability to manage its capital and credit conditions will be the biggest story for 2016. The Chinese economy has consistently needed very high levels of credit growth to support domestic activity. Strong current accounts, the accumulation of foreign reserves, a "closed" capital account and the repression of the household sector made this possible.

There are signs of weakness in this structure that has enabled this credit creation. The weakness began to emerge more than two years ago when gross capital outflows started to surge. The gross capital outflows now dwarf the surpluses created through trade (although the government (SAFE) has stopped reporting these gross flow numbers). The headlines surrounding reserve declines are relevant, but the only reason that the foreign reserves aren't

deteriorating much faster is because the rest of the world is providing an enormous amount of new loans to China, effectively capital is still flowing in to part match the outflows.

We expect capital outflow pressures have increased on rising CNY/USD depreciation expectations and narrower China-US interest rate differentials. The yuan has already depreciated by 5% in USD terms since July. The conditions are set for ongoing outflows as domestic wealth anticipates further depreciation.

The PBOC signalled its intentions for the further depreciation of its currency via looking to link the yuan to the currencies of its broader trading partners and away from the loose USD peg that has been in place. The comparative currency basket will be composed of the dollar, euro, yen and 10 other currencies. It's clear that such a change would result in further devaluation. This will lead to further capital outflows (and incrementally lower capital inflows), especially as interest rates between China and the US converge in the coming months.



Source: Capital Economics

Net capital outflows reduce domestic liquidity. It is customary for a debt fuelled expansion to face problems of asset quality, and in China the list of troublesome assets is long. History suggests when the music stops the banking sector reassesses the real value of assets, the government plays a role, the debt is written down or nationalised and the economy moves on. Only when the debt is denominated in foreign currency do issues arise. China risks (or should we say those who have lent to them risk) destabilising currency moves and refinancing risk.

So why not just devalue further? Indeed they may, but the issue is complicated by the nature of the flows. If the capital outflows are simply fleeing China, as many Australians believe, then the price of foreign money, as to the price of the house or business they are buying, doesn't matter.

Devaluation in these circumstances wouldn't change capital outflows a great deal, but they may affect the confidence of those supplying new loans to China. In a world which may see rate normalisation in 2016, Chinese assets may have already suffered from weaker relative demand without such a shock.

In Australia, differences in the outcomes for credit and capital flows are critical, especially in the case of devaluation, tightening of capital outflows, and a drying-up of the supply of foreign loans to China.

In such a scenario, Australia's relative prices would rise, tradeable inflation would fall (potentially offset by a lower AUD), and domestic demand would be weaker still. Commodity prices would fall further and demand for iron ore and coal would also diminish. The flow of speculative capital into Australia for housing could slow or reverse, causing a bursting of the housing bubble. Australia's capacity to service our indebtedness to the rest of the world would be weakened by lower nominal growth, thus reducing our capacity to attract foreign capital.

For Australia, at the tail-end of a commodity boom and not having had a recession for 23 years, it is tempting to downplay the role of capital flows in Australia. We might delude ourselves that the capital inflows we need from places like China will always be there. But Australia too has moved up the risk curve that now surrounds capital flows because it is seen as an appendage to China's economic wellbeing.

From a portfolio perspective, we are increasingly more cautious on exposure to China.

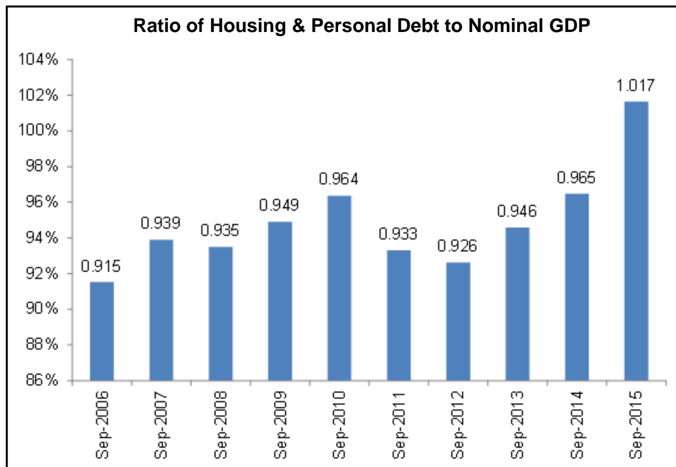
Australia: Under transition

We believe 2016 will be a year of transition for the Australian economy, due to an ongoing decline in the terms of trade, lower population growth and reorientation away from the Mining sector.

The return of a re-leveraged household sector, sparked by lower rates, resulted in higher house prices. Other factors contributed, such as increased capital flows; however investor housing debt was the key factor. This has contributed to a riskier economic environment.

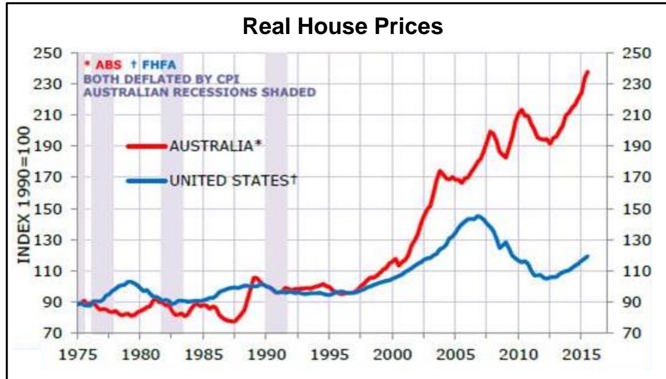
A clear indication of this re-leveraging is the ratio of housing debt outstanding to nominal GDP. With nominal GDP very weak and housing credit stronger, all of the deleveraging since the GFC has now been reversed.

The terms of trade boost Australia received in 2010/11 supported government coffers and household balance sheets. This benefit has now reversed. Any credit growth now needs to be supported by improved incomes.



Source: JCP Investment Partners

Changes in bank credit reporting in 2015 have highlighted that much of the recent credit growth has been in investor lending. The magnitude of investor lending has been unprecedented, with the share of the increase in credit due to housing investors averaging 55% in 2014 and 2015 despite averaging only 25% for the previous 22 years. This has fuelled a rapidly appreciating housing market well beyond the growth seen in the US (see chart below).



Source: Minack Advisors

Recent macro-prudential regulation, such as a cap on investor lending has seen this growth dynamic change, with investor lending now falling, and a rush of investors reclassifying themselves as owner-occupied.

The deterioration in housing affordability, slowing population growth, constraints on investor lending and expected restrictions on foreign buyers are expected to drive a downturn in residential market conditions over the next 6-12 months, as house prices follow the decline of clearance rates (see following chart).

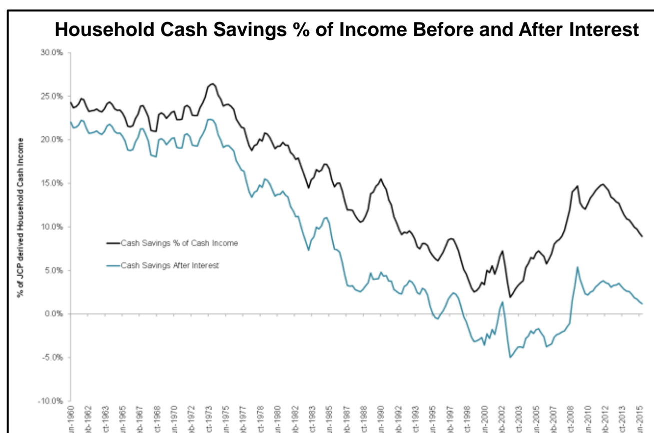
Source: Minack Advisors

At JCP, we believe it is critical to understand whether recent re-leveraging was due to improved confidence, or due to speculation (based on rising prices). Such determinations will create vastly different monetary policy considerations.

What really concerns us is the lack of income growth, as income growth is the sustaining force required in the economy and ultimately equity valuations. On incomes, the signals are clear; using National Accounts, nominal compensation per employee is falling; using price indexes, the ABS Wages Price growth is at record low levels; using cash, the Federal Government's expected levels of taxes collected continue to wane.

The strong credit impulse but underlying weakness in incomes, is affecting the economy in different ways. Income weakness and low expectations of future nominal growth limit the upside from non-mining investment, and activity in other parts of the non-housing economy. Credit growth is stimulating housing construction directly and indirectly through house prices. Momentum in building approvals is softening, with total approvals falling now for the seventh consecutive month in trend terms. Approvals for renovation activities continue to weaken, and approvals for non-residential building remain at a low level. With house prices now softening and sentiment in the sector shifting, we expect the tailwind from housing construction to fade further in 2016.

Our economy cannot rely solely on the credit impulse as we move forward. Despite low interest rates, a higher level of borrowing has meant that much of the gains in savings since the GFC have now been spent (see chart below). Spending without income, whilst increasing leverage, only works for so long and would be detrimental in a global rising rate environment.



Source: JCP Investment Partners

As we head into 2016, it is clear that Australia continues to face a long period of structural adjustment. We expect further challenges ahead, such as; a raft of measures to control and monitor foreign buying including higher costs and greater compliance; changes in the lending behaviour of banks, such as a further tightening on investor lending; and if historical precedent holds, the declining terms of trade will continue to see slower population growth for many years to come. Furthermore, lower government deficits (although unlikely) have the potential to be a drain on the economy. Actions to remedy budget pressures will no doubt crimp demand and confidence.

In regards to employment, we remain sceptical of recent labour force strength due to the extraordinary share of the reported job growth that has come from sample rotation – employment is rising because we are asking different people month to month, not because the same people are more employed than last month. Whilst a couple of additional strong prints are likely, the risk remains that sample rotation (which otherwise should be neutral for jobs growth) normalises in the coming six months. Our detailed analysis of the micro data underneath the reported number highlight an array of inconsistencies that former ABS head Bill McLennan suggested meant “the results of the last six months aren't worth the paper they're written on”.

The external and structural risks for the domestic economy are very high, and face being compounded by a reversal in short-term credit growth. Without levers for sustained productivity growth at hand, and a low likelihood of massive government infrastructure stimulus in 2016, we see domestic conditions being challenging.

In such an environment the risk of bad debts and higher unemployment are positively skewed.

The benefits of a lower AUD in a rising interest rate environment in the US should be translated into some strength in import competing sectors (where they still exist). However without a good handle on the real growth in speculative housing investment, the RBA remains challenged, as any requirement to lift rates to curb financial excess will result in a higher AUD, impacting our international competitiveness.

We note with interest the BIS wrote in their Annual Report, *Chapter 1 Is the unthinkable becoming routine?* that persistently extraordinarily low interest rates “runs the risk of entrenching instability and chronic weakness”, and furthermore that “domestic policy regimes have been too narrowly concerned with stabilising short-term output and inflation and have lost sight of slower-moving but more costly financial booms and busts.”

As the risks rise however it is important to position towards industries that will benefit from (as the BIS referred), “a rebalancing in national and international policy frameworks... to (policies that) rely less on demand management policies and more on structural ones, so as to abandon the debt-fuelled growth model that has acted as a political and social substitute for productivity-enhancing reforms.”

From a portfolio perspective we have continued to steer away from purely cyclical domestic exposures (e.g. discretionary retail, construction), and late cycle domestic economic proxies such as the commercial banks, preferring domestic exposures that are less leveraged to the broader economy.

Australia: Equity market outlook

Last year we forecast a +4.4% price return for the Australian All Ordinaries Price Index, with +/-12.9% risk around this forecast (see table below).

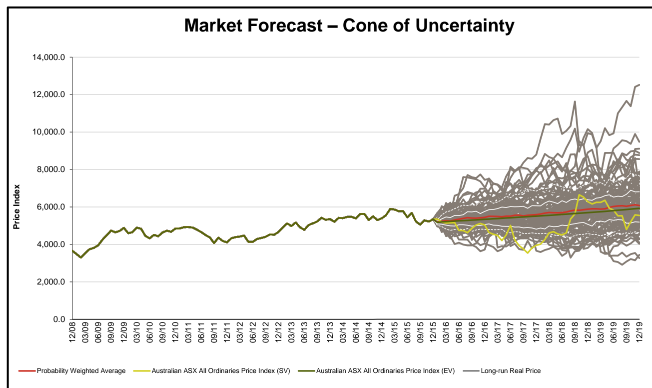
Year ended 31st December 2015	Probability	ASX All Ordinaries Price Index			ASX All Ordinaries Price Index Return		
		From		To	From		To
Units of measure:	%	Index	Index	Index	%	%	%
As at 31/12/15			5570.9				
Scenarios:							
Best case	10.0%	7051.6	-	9161.1	+26.6%	-	+64.4%
Optimistic case	15.0%	6544.6	-	7051.6	+17.5%	-	+26.6%
Base case	50.0%	5187.7	-	6544.6	-6.9%	-	+17.5%
Pessimistic case	15.0%	5187.7	-	4742.8	-6.9%	-	-14.9%
Worst case	10.0%	4742.8	-	3743.5	-14.9%	-	-32.8%
Total | Probability-weighted return	100.0%	5096.1	5815.3	6534.6	-8.5%	+4.4%	+17.3%
Probability-weighted risk						12.9%	
Return difference versus expeced return			5692.1			+2.2%	

The All Ordinaries Price Index returned -0.82% (towards the middle of our risk confidence interval of -8.5% to +17.3%).

Our 2016 forecast for the Australian All Ordinaries Price Index is for a low capital return of only +1.8% reflecting our view that the market is currently still only fair value despite the negative start to 2016 (i.e. currently a 1.6% discount to our market-cap weighted bottom-up valuation universe). The risk around this expected return is +/-11.8%, and so we expect a 66.6% probability of a return between -10.0% to +13.7%. Our scenarios for calculating these probability-weighted return and risk figures are shown in the table below.

Year ended 31st December 2016	Probability	ASX All Ordinaries Price Index			ASX All Ordinaries Price Index Return		
		From		To	From		To
Units of measure:	%	Index	Index	Index	%	%	%
As at 31/12/15			5344.6				
Scenarios:							
Best case	10.0%	6250.3	-	7448.0	+16.9%	-	+39.4%
Optimistic case	15.0%	5761.2	-	6250.3	+7.8%	-	+16.9%
Base case	50.0%	5060.3	-	5761.2	-5.3%	-	+7.8%
Pessimistic case	15.0%	5060.3	-	4802.3	-5.3%	-	-10.1%
Worst case	10.0%	4802.3	-	3723.3	-10.1%	-	-30.3%
Total | Probability-weighted return	100.0%	4809.9	5442.9	6076.0	-10.0%	+1.8%	+13.7%
Probability-weighted risk						11.8%	
Return difference versus expeced return			5339.1			+1.9%	

We also show below our forecasts as a 'cone of uncertainty' for the next four years. The best case scenario is the top 10th percentile of stochastic returns (above the white dotted line; the optimistic case the 75th to 90th percentile (between the solid and dotted white lines); the base case the 25th to the 75th percentile (between the two solid white lines); and so on.



Source: JCP Investment Partners

Despite our expectations for low capital returns in 2016, we expect that those companies and sectors exposed to offshore earnings or exports to do relatively better than those exposed to the domestic economy.

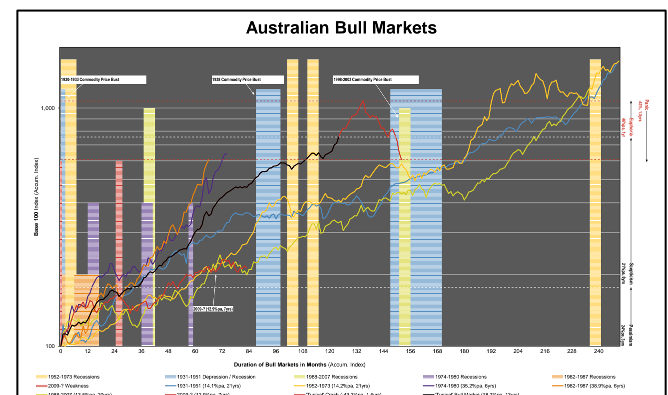
Commodity prices have again fallen a long way in 2015, and are now well below our long-term equilibrium prices. Given the excess supply in most commodities, and the relatively weak demand outlook, we recognise that commodity prices could still fall further in the next couple of quarters; however most of this downside risk is now factored into market expectations and stock prices. Furthermore, the 'contractual' capital flows related to mining and energy investment projects should start to dissipate in 2016, and the forced reduction in 'excess' capital outflows from China to Australia, should cause further weakness in the Australian dollar and continue to benefit companies with offshore earnings and exporters (including resources stocks), once commodity prices stabilise.

Domestic Industrials, on the other hand, continue to face rising costs (from the weaker Australian dollar), and weakening demand as the income shock from the fall in Australia's terms of trade (>34% since June 2011) continues to negatively impact the highly indebted household sector's disposable income (and also the Government's fiscal position).

If the growth in 'excess' Chinese capital flows to Australia disappears, this will put downward pressure on asset prices. Without the ability to access liquidity from rising asset prices, servicing high debt levels in a low income growth environment will become increasingly difficult for Australian households, thus increasing bad debt charges for the Australian banks.

Further cuts to interest rates may offset some of these negative effects, but much of this 'fire power' has already been expended by the RBA with (arguably unnecessary) interest rate cuts from 4.5% to 2.0% (since August 2011), especially in an environment where US interest rates looks set to rise further over the next few years.

Despite our view of low price returns over the next 12 months, given that we see the Australian market as fundamentally fair value from a bottom-up perspective, longer-term we remain very bullish. In bull markets confidence drives fundamentals higher via increased business investment and innovation, which in turn drives employment, household incomes, consumer confidence and spending, and ultimately business profitability and equity markets. This demonstrates the 'reflexivity' that exists between equity markets and the economy. This virtuous cycle is illustrated in the chart below which shows Australian bull markets for the last 100 years, and plots the progression of the post 2009 bull market (the red line originating at 100).



Source: JCP Investment Partners

The post 2009 bull market appears to be following a similar pattern to the 1988-2007, 1952-1973, and 1931-1951 bull markets. The compound average annual return for the post 2009 bull market has been 12.9%p.a. – versus 13.5%p.a, 14.2%p.a, and 14.1%p.a, respectively for these earlier bull markets.

Portfolio Positioning

The portfolio remains positioned for two key themes:

1. **Weakness in the domestic economy**
2. **A continued improvement in the US economy**

The major **overweight sectors** for the portfolio are: Insurance, Consumer Services, Commercial Services & Supplies, Food & Drug Retailing, Media and Software & Services.

The major **underweight sectors** for the portfolio are: Banks, Real Estate, Energy, Telecommunication Services and Utilities.

The portfolio has delivered strong outperformance over the past year and given our strong conviction on the current positioning of the portfolio, we expect this outperformance to continue given we are in the early phases on this current performance cycle. The portfolio continues to be well positioned for the economic headwinds we see facing the Australian economy over the next few years, whilst we continue to exploit a number of fundamental valuation versus pricing anomalies that exist in a number of stocks and sectors driven by panic and fear on the one hand and unsustainable expectations and structural headwinds on the other hand.

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