JCP Investment Partners – Market Outlook 2017

January 2017

2016 was a relatively strong year for global equity markets with many of the gains arriving late in the year. After a strong rebound in the December quarter (+4.2%), the Australian equity market finished the year at its highest level since August 2015, recording a 7.0% gain (ASX 200) for the calendar year. The best performing sector was Materials, gaining 39%, whilst the worst performing sector was Telcos, falling 12%, The US markets were stronger, with the Dow (+13.4%), S&P 500 (+9.5%) and Nasdaq (+7.5%) all finishing strongly post the Trump election win and the Fed raising rates late in the year in a sign that the US economy is improving. The UK also posted strong gains for the year (+14.4%) with much of the gains coming post the Brexit vote, whilst Germany (+6.9%) and France (+4.9%) lagged, given continued uncertainty regarding upcoming European elections and the general instability in the Euro region. In Asia, China was again extremely volatile, finishing lower (Shanghai Composite: -12.3%), whilst Japan was flat (+0.4%).

We expect the Australian equity market to be flat in 2017, delivering a capital return of 0% (with a risk of +/-14% around this forecast), and an expectation that it will most likely continue to under-perform developed global equity markets. This flat return expectation reflects our view that the Australian market overall is currently expensive given its strong rally in late 2016 and we expect conditions in 2017 to be less favourable as the US continues to normalise interest rates.

We believe that higher nominal growth, stimulated by expanding fiscal policy and its multiplier effects, will be unambiguously good for equity markets in the medium-term, despite higher interest rates. Financial repression will continue to keep interest rates well below expanding nominal growth for some considerable period creating a very positive medium-term macroeconomic backdrop for equity markets.

However, leveraged economies and business models built on the fallacy of "lower forever interest rates" will be tested over the next 12 months. As Warren Buffet once quipped, "Only when the tide goes out do you discover who's been swimming naked." Obvious leveraged (i.e. "naked swimmer") candidates include:

- Emerging economies with US dollar denominated debt
- Countries dependent on foreign capital inflows (e.g. Australia)
- Investment products leveraged 3:1 to enhance returns (e.g. wealth management products in Asia and highly levered infrastructure investments)
- Economies with recent excessive credit growth (e.g. China)

If past form is any guide, then a short-term equity market correction is highly probable if the risks from excessive leverage unfold. Such a correction would provide a great buying opportunity. Once these excesses are cleared, an inflationary environment of 2-4% for equities should be positive, sowing the seeds for the continuation of this bull market, certainly until interest rates become restrictive on the economy.

United States

Bullish outlook for the US economy

Despite the risk that equity markets can get ahead of themselves in the short-term, we begin 2017 with a bullish outlook for the US economy. We believe that the Trump election win is unequivocally good for the growth prospects of the US economy. Trump has been able to ride the wave of rising populist pressures and the shift towards anti-globalisation to capitalise on the anger of disaffected voters.

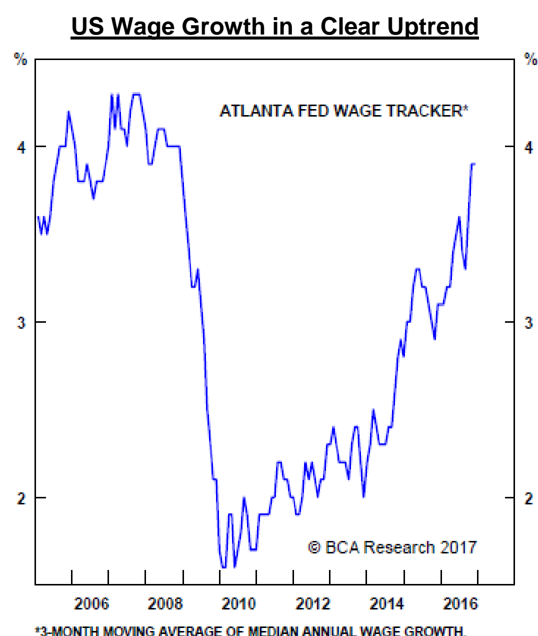
Growth will once again become the priority, with fiscal stimulus at the forefront. Inflation and interest rates will head higher, given the combination of a stronger economy, easier fiscal stance and monetary tightening are all consistent with rising bond yields. Change that prioritises local employment, isn't fearful of rate normalisation and seeks two-sided benefits from trade policy will be good for equities, until rates and inflation are significantly higher than current levels.

Reasons for our bullish outlook:

i). Tighter labour market:

The US labour market is already quite tight, with the recent drop in the unemployment rate close to a nine year low of 4.7%. Wages are growing at their fastest pace in eight years, according to the Atlanta Fed's wage tracker.

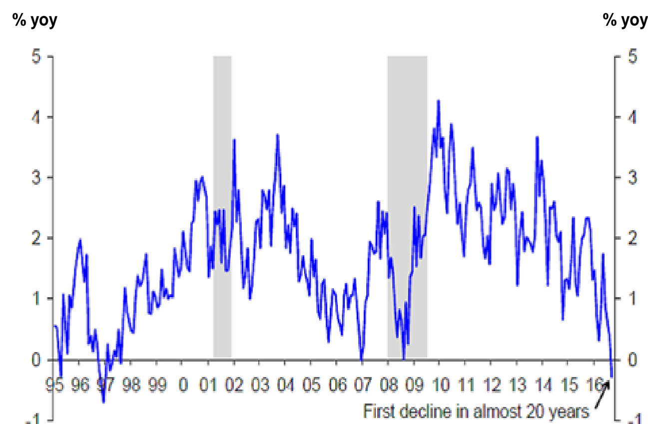
US Wage Growth in a Clear Uptrend



Source: BCA

There is now a decline in the number of people outside the labour market in the US for the first time in almost 20 years. As the chart below illustrates, this is consistent with the mid-1990s and 2006, times when the economy was also at full employment. Fewer outsiders in the labour market means the bargaining power becomes greater for insiders, resulting in upward pressure on wages.

US Population Not in the Labour Force (aged 16+)



Source: Deutsche Bank

Given the US economy is largely consumption based, higher wages are critical to ensure the virtuous cycle of growth and consumption continues to improve.

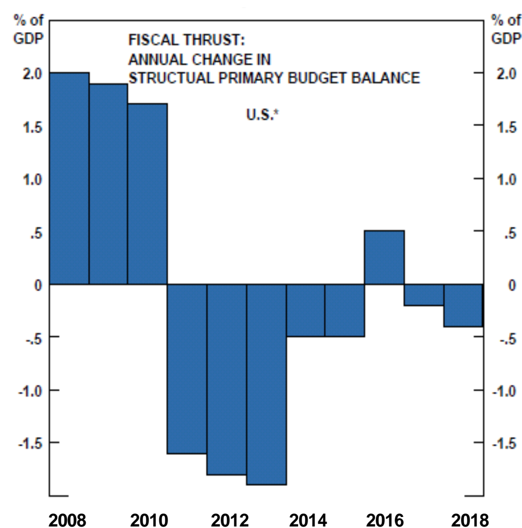
ii). Fiscal expansion has a major role to play:

The proposed fiscal expansion, and infrastructure programs (whilst more a story for 2018 and beyond, than 2017) will be applied to an economy already primed to generate inflation.

Near full employment, with sustainable medium term growth in housing starts, productivity enhancing developments in energy and supply chains and huge quantities of money ready to be deployed, the US has an exceptionally powerful base to stimulate with both supply side and demand side measures.

Having been a drag on the economy for the past 4-5 years, fiscal policy should provide extra impetus to the US economy. Trump has embraced deficit-expanding policies in his campaign speeches; his proposals would raise the deficit by over $1 trillion per year. As a percent of GDP, Trump's stimulus would equal roughly 5%. Fiscal expansion of this nature is likely to boost US GDP and create new jobs.

US: Structural Primary Budget Balance Annual Change



Source: BCA

How this is financed will be critical. It is likely that government debt will rise and therefore long-term interest rates will rise. Long-term real interest rates would be expected to rise sharply as the markets try to digest a large rise in debt.

iii). Tax cuts:

Trump's proposed tax reforms are large and wide ranging. He plans to reduce the personal income tax from 7 brackets to 3 and lower these tax rates. He also plans to cut the corporate tax rate from 35 per cent to 15 per cent and give a reduced tax rate of 10 per cent to corporations that repatriate funds held offshore back to the US. He also plans to abolish the inheritance tax. The likely cut in the US corporate tax rate from 35% to 15% is a major positive for US corporates; their profitability, and, hopefully, capital spending. In addition, creating less regulation and more government spending will likely boost productivity. This combined with the push by US corporates towards greater automation will further boost US corporate profits.

Risks:

Principle risks leading into 2017 relate to a possible rise in geopolitical tensions, uncertainty regarding trade policy and the manner in which the incoming administration seeks to "jumpstart" the US economy with fiscal, taxation and legislative initiatives. Chances are the road will be bumpy, the outcomes disappointing and the scope for change overstated. But whether Trump succeeds or otherwise in reversing any of these trends is moot for the moment.

i). Rise in geopolitical tensions:

The Chinese/US rivalry will be the main geopolitical risk to investors in 2017. Tensions have been building between the two countries for several years. The two countries have

fundamental, structural problems which appear to lead to inevitable conflict, be it in trade or some other form. We flagged these geopolitical risks in September post our US trip, which are likely to result in increased volatility for markets. In this type of environment, exposure to companies with US derived revenue remains appealing. In addition, a modest position in gold provides some protection in what is likely to remain a very unsettled geopolitical environment.

ii). Trade Policy:

It is too early to make predications on the potential for a US/China trade war, given we must first observe the US Administration actions. However, any moves to restrict global trade, to reprice imports (through tariffs or border tax adjustable taxation regimes) will have a material impact on global relative prices, and inflationary expectations. Border adjustable taxes for instance, are inflationary and an effective devaluation of the currency from the perspective of foreign exporters, and are likely inconsistent with WTO permitted behaviours.

iii). Lack of capital investment:

US corporates to date have shown an unwillingness to invest, with the trend in capital goods orders remaining very lacklustre. It is hoped that the prospect of lower corporate taxes, reduced regulation and a repatriation of overseas earnings will all combine to revive the corporate sector's animal spirits and thus their willingness to invest. Such actions will improve the supply side of the economy, helping to suppress the cyclical pressures on inflation, ensuring the cycle can run for longer.

In summary, the fundamentals of the US economy appear healthy. Time will tell whether Congress dampens Trump's efforts to boost growth, but with the Republicans clear winners, Trump may well gain support for his growth initiatives.

In this type of environment, having exposure to USD earners, minimising exposure to bond proxies, and understanding the impact of rate normalisation on the Australian economy will be critical. We feel that our portfolios are well positioned as the market rotation shifts away from a yield focus towards growth.

China

Unbalanced economy makes us cautious

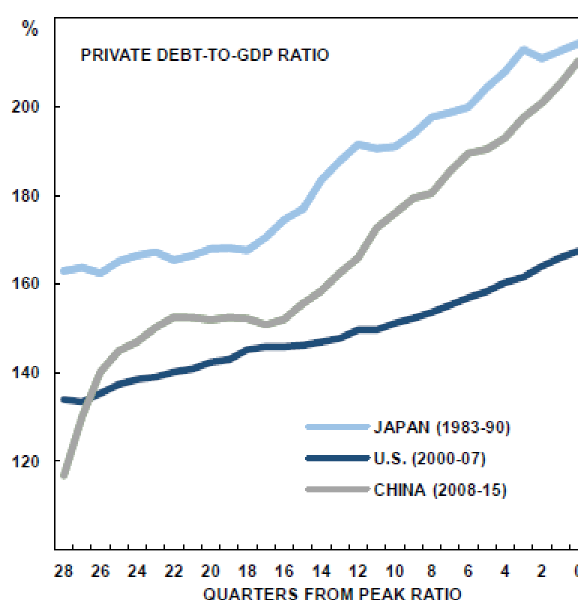
We remain cautious towards China due to the major imbalances resulting from an excessive reliance on credit creation to generate investment-led economic growth. Whilst significant supply side reforms are necessary, their Government has the levers to prevent a hard landing in the next few years. China's impact on Australia is more worrying from an Australian equities perspective.

Reasons for our cautious outlook on China:

i). Unhealthy and unsustainable growth in credit:

China's economy continues to be propped up by unhealthy and unsustainable growth in credit. The increase in China's Debt to GDP ratio over the past few years' dwarfs that seen during the ultimately disastrous credit booms of Japan in the 1980s and the U.S. in the 2000s. Whilst Chinese Debt to GDP has risen rapidly in recent years, much of this debt is denominated in RMB, and is concentrated in the private sector, somewhat reducing whole economy risk.

China's Credit Boom

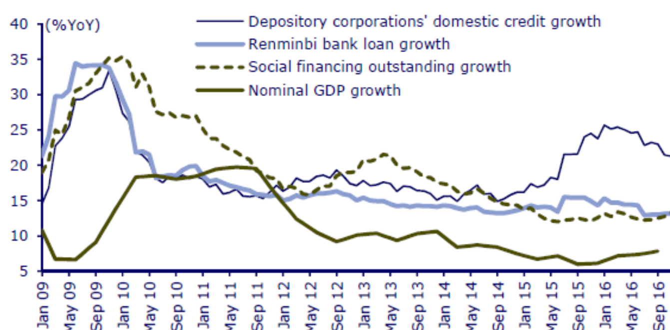


Source: BCA

2016 marked another bout of stimulus, as large in many ways as 2009. It is very clear that when China is under pressure stimulus remains the go-to policy. Risks remain that further stimulus will occur, with project approvals for 4Q16 amounting to Rmb 637bn, almost double the 376bn of approvals in 3Q16. The acceleration in central government approvals coincides with local governments tighter policy on housing. This is set to be a theme in 2017: weaker real estate investment, stronger infrastructure investment.

What is particularly interesting and relevant, is the declining efficiency of credit on nominal GDP; i.e. it is taking far more credit to generate growth, which is clear from the chart below. Without reform or writing off existing debt, such a divergence between the rate of credit and GDP growth is clearly unsustainable.

China: Credit Growth and Nominal GDP growth



Source: CLSA

Given the debate around fiscal policy in China is about how much and for how long, the 19th National Communist Party Congress, which is due to be held in Sep/Oct 2017, will be a key political event to watch.

ii). The stop-start nature of policy in the absence of supply side reforms:

The over-reliance on fixed asset investment (FAI) in China to generate growth, lends itself to a stop-go policy. The real estate sector is a case in point, where policy has been relaxed and tightened many times to ensure overall growth targets are met. Over time, the Chinese economy should gradually become less dependent on construction and other credit-intensive activities. However, in the near-term, there is no escaping the fact that the economy will remain unbalanced. This creates a difficult environment for the country's currency and assets markets. The Government has sufficient levers in place in the short term, but ultimately more supply side reforms will be required.

Supply side reforms should begin to intensify in 2017, with the Government planning to cut coal production by another 300 million tonnes, whilst on steel, the state media reported that the production cut will increase by at least 10% in 2017. Going forward, production cuts will also extend to cement, glass and aluminium.

iii). China's impact on Australia:

Australia relies on China for migrants, high prices for raw materials and huge levels of capital flight. The pace of change and effectiveness of Chinese capital controls will have two key impacts in 2017. JCP has contended for a couple of years that whilst the net flows of capital are interesting, the net number hides two flows. The flows into China, and the flows out of China are both critical but driven by vastly different sets of data and expectations.

If flows into China (trade surplus, inbound investment, external financing) remain high because the rest of the world supports trade and is confident in the Chinese economy and banking system, a huge level of outflows can be sustained. These outflows can support migration and tourism to Australia, support the transfer of vast quantities of residential real estate and farmland abroad and allow China to purchase required innovation and technology.

The greater the inflows, the greater the outflows that can be supported while retaining a buffer of reserves. The greater the inflows the more support for the exchange rate, and the lower the expectation of devaluation and pursuant capital flight.

We believe cracks must be emerging in the inflows, because the Chinese government is now more concerned about shoring up the outflows, even in circumstances where such a flow would be beneficial such as foreign investment by Chinese firms.

The implication is that the inflows are slowing. In a period of weaker inflows, the PBOC will either close the significant holes in the existing capital controls, impacting on Australian real estate, investment, trade and tourism, or allow the exchange rate to devalue against the basket of currencies along with the US and trigger a global response. Both are risk-off events for Australia. Both would increase the risk premium Australia requires and both would see the AUD fall and our funding costs rise. We believe that our portfolios should account for these risks well.

In summary, we remain cautious towards China due to the major imbalances resulting from an excessive reliance on credit creation to generate investment-led economic growth. Whilst major supply side reforms are necessary, their Government has the levers to prevent a hard landing in the next few years. China's impact on Australia is more worrying from an Australian equities perspective. The emerging geopolitical risks, particulary the potential for a trade war with the US may also dampen commodity demand.

Australia

Australia's key growth drivers have become riskier

Whilst the developments in the US described above are unequivocally good for the growth prospects of the US economy, we believe that Australia's vulnerability is higher in this new world because Australia relies on foreign capital for financing domestic capital accumulation and gains a great deal from open international markets. If we are at the end of globalisation, economies that are highly leveraged or sectors where there has been substantial mispricing of assets will come under pressure as assets are repriced. As such, we believe Australia's key growth drivers have become riskier.

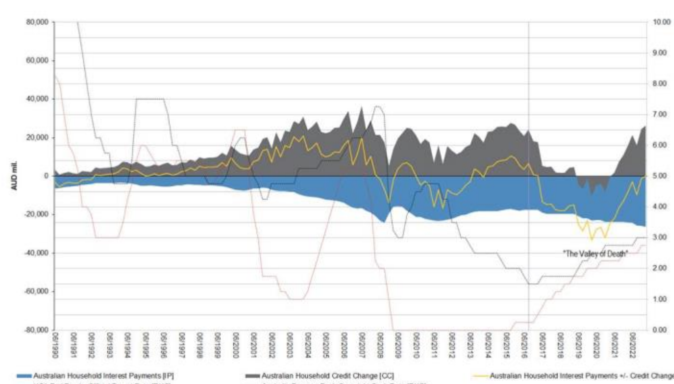
i). Rate normalisation will not be easily accommodated in Australia

The proposed fiscal expansion in the US economy will lead to an increasing interest rate environment globally. For a small open economy like Australia, which is dependent upon

foreign debt to fund itself, rates locally will rise (if not by the RBA, then the rates imposed by banks due to higher funding costs). This environment will be bad for the household sector given the high level of indebtedness and historically low income growth to support this debt.

When global interest rates are normalising there is a view that Australia will simply be able to ride a steepening yield curve and a lower currency through any adjustment process. We believe that asymmetric risks of higher rates in the coming years will be required to support the economies capacity to roll our foreign debt. The likelihood of higher rates is especially relevant to mortgages which are likely to continue to rise "out-of-cycle" as they have in recent months. Even if rates do not rise, our analysis shows the domestic economy needs rate cuts, not just flat rates to maintain current consumption.

Financialisation of the Australian Household Sector



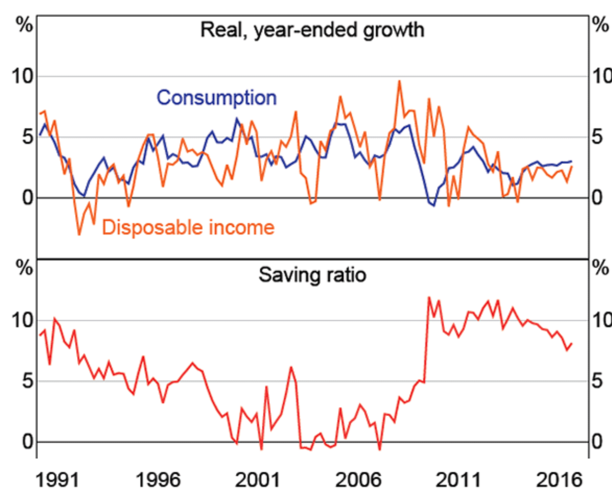
Source: JCP Investment Partners

As illustrated in the chart above, the US forward interest rate market now implies that the Fed will increase its rates by 225bps to 2.5% between now and 3Q2022. *Ceteris paribus*, this will put pressure on the RBA to also raise its rates by a similar amount; currently implied in the Australian forward market. This will cause a large shock to the Australian household sector, resulting in less credit availability and higher interest payments (see yellow line in the chart above which depicts the credit impulse within the economy).

ii). Wage inflation now below 2%

Another area of concern is the lack of income growth in Australia. Year ended wage inflation slowed to 1.9% from 2.1%, a new historical low for the series. Over the past few quarters, real wages have fallen, resulting in a cost of living squeeze on consumers, and slower spending growth. Anaemic consumption growth over the next year is expected, in part because of the decline in discretionary income, but also because of deleveraging pressures, and weakness in housing demand. This lack of income growth has also resulted in a declining savings ratio, as households save less to support their consumption (see following chart).

Australian Household Income, Consumption and Wealth



Source: ABS, RBA

The recent 3Q national accounts pointed to clear evidence of the slowing of the household sector, and a weakness in the supposed "rotation" of the economy away from mining investment.

iii). Higher commodity prices aren't going to save us this time

The temporary boost in our terms of trade from the Chinese stimulus package at the back half of 2016 will only highlight the weak transmission mechanisms of the post-boom economy. In the previous cycle rising terms of trade fed into domestic activity through two channels that are now blocked. First, last cycle the Federal government's terms of trade windfall were quickly passed on to voters as tax cuts and spending increases; this time any windfall will likely be used to reduce the deficit. Second, last cycle rising commodity prices went hand in hand with rising mining investment; this time mining capex remains in decline.

What is less clear relates to the context of the previous terms of trade booms. Each was accompanied by a surge in private credit and the growth of money supply through housing debt. On each occasion the RBA saw low inflation, driven by higher AUD and Chinese over investment, and decided to cut rates. Pumping higher consumption, and higher debt loads to drive private demand. When demand softened along with the terms of trade the RBA went back to the well of rate cuts, hoping the AUD would fall, sacrificing short term consumption for higher balance sheets risks. We believe that the new RBA Governor Phillip Lowe understands this was, if not a mistake, not a relevant strategy going forward.

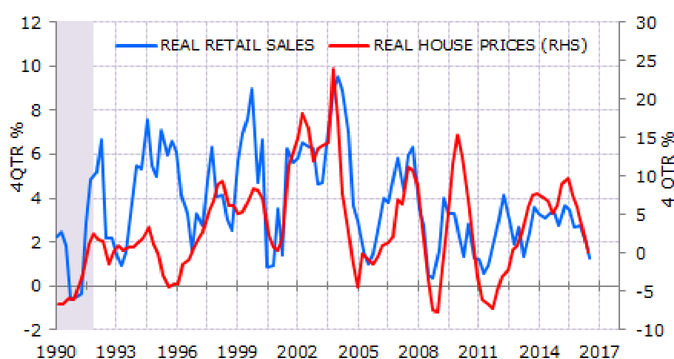
iv). The housing boom looks set to fade

A long overdue correction in housing approvals is now in progress (-12.6% mom in October, to be -24.9% lower over the year) albeit the private house component remains far more stable than the volatile multi-dwelling sector. The unprecedented surge in apartment construction particularly in

inner-city Brisbane and Melbourne, has pointed to looming excess supply for some time, as such we expect continued declines in dwelling approvals through 2017.

In addition, the annual rate of growth in house prices decelerated to 3.5% yoy in 3Q2016 (according to the ABS), a 3.5 year low and materially slower than at the same time last year (+10.7%yoy). It would be a major growth headwind if house prices started to decline along with housing construction, given the link between house prices and broader consumer spending (see chart below).

Australian House Prices and Retail Sales



Source: Minack

In summary, the major implication of our analysis above is that companies exposed to a highly indebted Australian household sector (e.g. property developers, discretionary retailers, retail-focused REITs, commercial banks, etc.) will confront a much more challenging and hostile earnings environment in the next few years. The strong historical tailwinds of easy monetary policy which has boosted household cash flows will probably slow significantly and, if our analysis is correct, possibly turn into strong headwinds as the RBA has used up most of its ability to sustain relatively higher credit growth rates to the household sector by continuously lowering interest rates. Overall, we view the Australian economy is weaker and more exposed to global risks of rising rates, geopolitical tensions, and change in the political landscape.

Australia: Equity market outlook

Last year we forecast a +2% price return for the Australian All Ordinaries Price Index, with +/-12% risk around this forecast (see 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%	

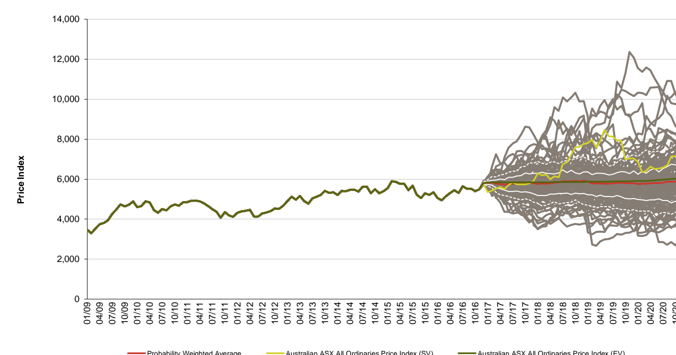
The All Ordinaries Price Index returned +7.0% (towards the upper end of our risk confidence interval of -10.0% to +14%).

Our 2017 forecast for the Australian All Ordinaries Price Index is for a flat capital return of 0% (versus our expected equilibrium capital return of +2% and a dividend return of 5%). This reflects our view that the market is currently over-priced by about 7% after a strong rally in the last quarter of 2016. The risks around this expected return is +/-14%, and so we expect a 66.6% probability of a return between -14% to +14%. However, medium-term we see the return risks skewed to the upside despite some short-term leverage risks factors (explained above). Our scenarios for calculating these probability-weighted return and risk figures are shown in the table below.

Year ended 31st December 2017	Range	ASX All Ordinaries Price Index			ASX All Ordinaries Price Index Return		
		From		To	From		To
Units of measure:	%	Index	Index	Index	%	%	%
As at 31/12/16			5811.9				
Scenarios:							
Best case	10.0%	6797.7	-	8220.2	+17.0%	-	+41.4%
Optimistic case	15.0%	6300.9	-	6797.7	+8.4%	-	+17.0%
Base case	50.0%	5272.0	-	6300.9	-9.3%	-	+8.4%
Pessimistic case	15.0%	5272.0	-	4849.0	-9.3%	-	-16.6%
Worst case	10.0%	4849.0	-	3690.0	-16.6%	-	-36.5%
Total | Probability-weighted return	100.0%	4962.2	5801.8	6641.3	-14.6%	-0.2%	+14.3%
Probability-weighted risk						14.4%	
Return difference versus expected return			5843.9			-0.7%	

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.

Market Forecast – Cone of Uncertainty



Source: JCP Investment Partners

Despite our expectations for flat capital returns in 2017, we expect that those companies and sectors exposed to offshore earnings or exports to do relatively better than those exposed to the domestic economy.

Downside pressures should start to build on the Australian dollar in 2017 as Australia's positive yield differential (versus US interest rates) narrows with further rate increases expected from the Fed in 2017. Also, 'contractual' capital flows related to energy investment projects should fall significantly in 2017, and the forced reduction in capital

outflows from China to Australia, should cause further weakness in the Australian dollar and continue to benefit companies with offshore earnings exposure.

However, metal and mineral commodity exporters may not benefit as much from a weaker dollar as other exporters because the strong rally in commodity prices in 2016 will probably correct somewhat in the year ahead given the expected further withdrawal of economic stimulus by the Chinese Government in 2017.

Domestic industrials, on the other hand, will continue to face rising costs (from an expected weaker Australian dollar), weakening demand from continued low household income growth and rising interest costs as banks look to recover higher offshore wholesale funding costs which will also negatively impact the indebted household sector's disposable income (and also the Government's fiscal position).

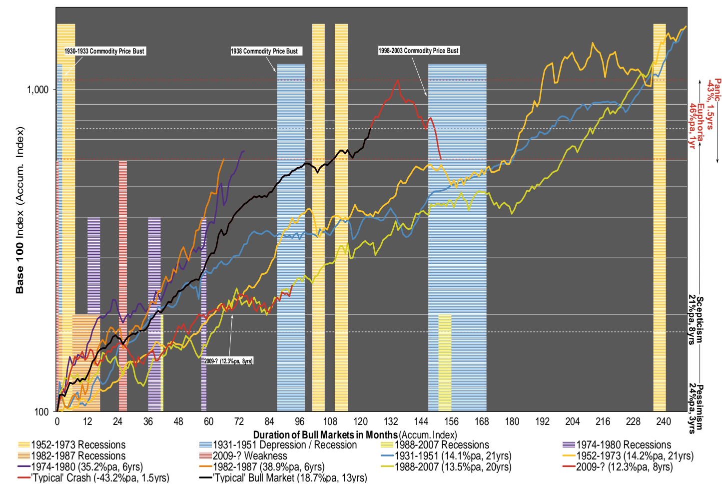
If the growth in Chinese capital flows to Australia disappears (as we suggest above), this will put downward pressure on Australian asset prices. Without the ability to access liquidity from rising asset prices, servicing high debt levels in a low-income growth and rising mortgage rate environment will become increasingly difficult for Australian households, thus ultimately increasing bad debt charges for the Australian banks.

Further interest rate cuts to ease pressure on the household sector now seems 'off the table' with a more hawkish new RBA Governor and in an environment where US interest rates looks set to rise much faster over the next few years.

Despite our view of a flat capital return over the next 12 months, given that we see the Australian market as moderately expensive from a bottom-up perspective, longer-term we remain very bullish. Developed world voters are fed-up with the impact of low nominal growth rates and the impact of this on wages and employment prospects; so, politicians and policy-makers will need 'to do whatever it takes' to increase growth (including monetisation of government fiscal expansion if need be).

For equities, this should lead to a virtuous cycle of higher nominal growth rates and ongoing financial repression (given high debt levels in most Developed economies) which will drive equity markets much higher over the medium-term. Such virtuous equity cycles are illustrated in the charts below which shows Australian and US bull markets for the last 100 years, and plots the progression of the post 2009 bull market (the red line originating at 100).

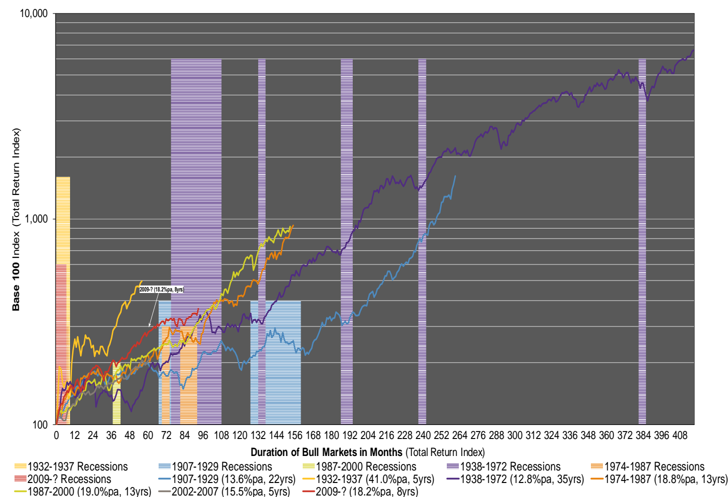
Australian Bull Markets



Source: JCP Investment Partners

The post 2009 Australian 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 12.0%p.a. – versus 13.5%p. a, 14.2%p. a, and 14.1%p. a, respectively for these earlier bull markets.

United States Bull Markets



Source: JCP Investment Partners

Portfolio Positioning

The portfolio is positioned for:

1. **Weakness in the domestic economy;** having little or no exposure to the Australian Banks and Discretionary Retailers;

2. **A continued improvement in the US economy,** and

3. **A rising bond yield environment.**

The major **overweight sectors** for the portfolio are: **Insurance, Food & Drug Retailing, Consumer Services,**

Media, Software & Services, and Healthcare Equipment & Services.

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

Conclusion:

The portfolio is well positioned for a continued improvement in the US economy, given the fundamentals of the US economy appear strong. In this type of environment, having exposure to USD earners, minimising exposure to bond proxies, and understanding the impact of rate normalisation on the Australian economy are critical. We feel that the portfolio is well positioned as the market rotation shifts away from a yield focus towards growth. We have avoided companies exposed to a highly indebted Australian household sector (e.g. property developers, discretionary retailers, retail-focused REITs, commercial banks, etc.) which will confront a much more challenging and hostile earnings environment in the next few years.

The strong historical tailwinds of easy monetary policy which has boosted household cash flows will probably slow significantly and, if our analysis is correct, possibly turn into strong headwinds as the RBA has used up most of its ability to sustain relatively higher credit growth rates to the household sector by continuously lowering interest rates. Overall, we view the Australian economy is weaker and more exposed to global risks of rising rates, geopolitical tensions, and change in the political landscape.

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