JCP Investment Partners - June Quarter 2014

July 2014

At the half way point of the calendar year, the Australian equity market (ASX300) is up +0.66%, in line with our January outlook which forecast a return for the Australian All Ordinaries Price Index of +1.8%, with risk around this return of 14.9% for the year. Our market underperformed the US S&P500 (+4.7%), the UK (+2.2%) and China (+2.6%), driven by weakness in the retail and materials sectors. Weak consumer sentiment, particularly post budget, weighed on the retailers with weak trading conditions reflected in many market updates. Elsewhere, the materials sector was weighed down by a softer iron ore price reflecting a slowing Chinese property market and less steel intensity.

We maintain our outlook that 2014 will be a year of continued, although modest, market strength for equities, driven by central banks remaining focused on avoiding deflation, encouraging employment, preserving liquidity and anchoring forward rate expectations. However, the second half of the year could be punctuated with both downside and upside volatility greater than what we have seen in the first half. The outlook for the domestic economy has arguably deteriorated recently, providing us with greater conviction in our portfolio positioning.

Europe

Recent data suggests that the global economy, particularly Europe, continues to struggle in the face of super-easy monetary policies. The recovery in Europe appears to have lost some momentum, with the latest eurozone manufacturing PMI at a seven month low, whilst unemployment is still elevated at 11.6%, continuing to be a drag on growth in household consumption.

Given this deterioration, it is not surprising that the ECB cut its key interest rates by 10bps and announced a series of credit easing measures recently, specifically a Targeted Long-Term Refinancing Operation initiative designed to stimulate corporate and household related lending.

Inflation remains well under the ECB's target of 2.0%, so there was scope for Draghi to cut rates, with the 10 year government bond yield in France now at its lowest level since 1746 and Italy's the lowest since 1945. These exceptionally low rates have weakened the Euro, supporting the global carry trade, which should support the AUD given the relative high yield on offer. The ECB has the further option to implement a large scale asset purchase programme if required.

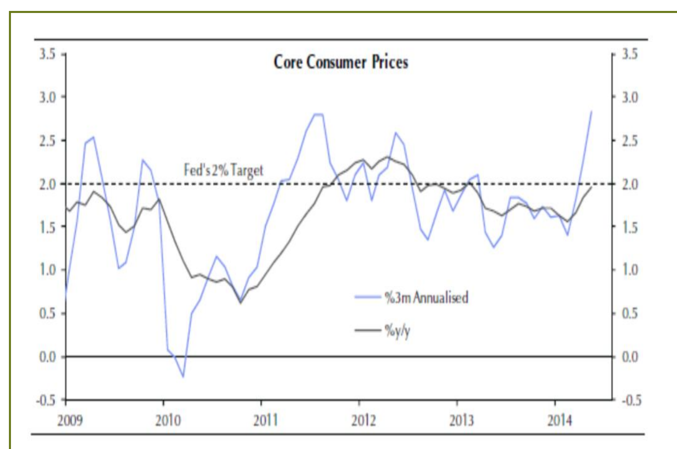
From a portfolio perspective we remain cautious on companies with eurozone exposure.

United States

Despite first quarter growth being impacted by extreme weather, the US economy is expected to show a rebound when Q2 GDP is released and continue to be strong for the remainder of the year. Recent ISM, PMI, payrolls and housing starts should ensure the growth trajectory remains positive. Unemployment recorded a post GFC low in June at 6.1%.

These improved signs led to the Fed cutting their bond purchases by another $10bn to $35bn per month recently, with expectations that the program would wind up later this year.

US CPI surprised the market to the upside, rising 0.4% in May, with 3 month annualised inflation increasing well above the Fed's 2% target (see chart below), pushing towards 3%.



This recent move has been driven by housing, energy, transport, medical, insurance and rent, essentially services and all the things that really matter. So what does this mean? It could be the first signs of broader based inflation in the US, especially given the fact that real hourly earnings have finally turned positive and that pay expectations (businesses planning to increase compensation) are rising. Importantly, the increase in US inflation was recorded across all three measures, namely Median CPI, Core CPI and Core PCE. It may perhaps be too early to claim anything on the inflation front of any magnitude, but there is some evidence that change is occurring.

Further signs of inflation will potentially ignite concerns that the Fed's plans for 2015 rate hikes might be serious, however we are of the view that central banks will err on the side of staying too easy for too long, allowing inflation to increase. Arguably deflation fears have been holding back borrowing and spending, so higher inflation will most likely be viewed as a positive development.

As long as economic growth remains strong enough to keep earnings from contracting but weak enough to sustain accommodative monetary policies, then markets will remain reasonably strong and this bull market will continue.

From a portfolio perspective, we continue to favour companies leveraged to the US economy, particularly those that can benefit from this incredibly accommodative environment.

China

We remain consistent in our view that China is experiencing a structural slowdown, albeit at a gradual pace. We expect that annual growth over the next decade is likely to be closer to 4% than 7%.

The Chinese Government continues to implement policy designed to maintain economic growth, cognisant of the broader structural slowdown. An example of these policies was the Peoples Bank of China's announcement that the Reserve Requirement Rate would be lowered by 50bps for banks that lend to small to medium sized enterprises, as well as consumer and auto loans. The loosened loan-to-deposit ratio should help boost activity in the 2H, with new loan quotas expected to increase.

The property market has been the major concern in China, with a retracement in Chinese property sales and construction starts in the first 5 months of this year. Efforts to stem this retracement are becoming evident with the Government fine tuning policy, such as the gradual relaxation of home purchasing restrictions in many cities. However developer inventories of unsold property is still growing, and as such real estate is likely to remain a drag on the economy unless more support measures are implemented.

Some of these policy measures are helping to stabilise the broader economy for now, with conditions in manufacturing holding up well - evidenced by the official PMI recording a 7 month high in June. Stronger external demand appears mostly responsible for the pickup with new exports strong. The state led rebound in infrastructure investment is also helping to offset the decline in the property sector.

Improved manufacturing activity such as we are seeing should support commodity demand as real estate slows, however steel demand will be slower and fall as China's structural reforms direct growth away from investment. This points to lower steel mill margins and ongoing pressure on iron ore and coking coal prices. This outlook is reflected in our long run iron ore forecast of US$70/tonne which we downgraded post our last trip to China in March.

From a portfolio perspective, we are happy to maintain exposure to the lowest cost producers of iron ore that stand to benefit from increased volume as they displace higher cost producers. Additionally, Australia is reasonably well placed to supply services such as education and tourism to the growing affluent Chinese consumer.

Australia

As mentioned above, the outlook for the Australian economy has deteriorated over the last quarter, with a number of major challenges ahead.

A sharp deterioration in consumer confidence post the Federal Budget has led to a spate of profit warnings predominantly in the retail sector. This hit to sentiment has been compounded by Australia's falling terms of trade, which have already fallen ~15% due to the decline in demand for Australia's two largest exports (iron ore and coal).

We expect the terms of trade to fall further over the next few years, resulting in lower national income. The flow though impacts could be significant for the industrial sector and eventually the banking sector, which we view as a leverage play on the Australian economy.

These trends are occurring against a backdrop of falling mining capex, lower commodity prices, a higher AUD and declining approvals for both residential and non-residential buildings (-5.6% in April).

We would argue that the RBA has lost control of monetary policy to a certain extent. Despite Australia having very low interest rates, monetary policy is having little impact on the economy (apart from an investor led housing boom on the east coast of Australia). Our low interest rates are not stimulating credit growth (both consumer and business credit growth are relatively benign), whilst the AUD is not falling (despite the RBA's best efforts) due to global interest rate differentials and Australia's AAA credit rating. Given our view that the Australian economy is weakening, the RBA may have no choice but to keep rates low for longer.

Given this outlook for the Australian economy, our market is likely to continue to underperform major global markets.

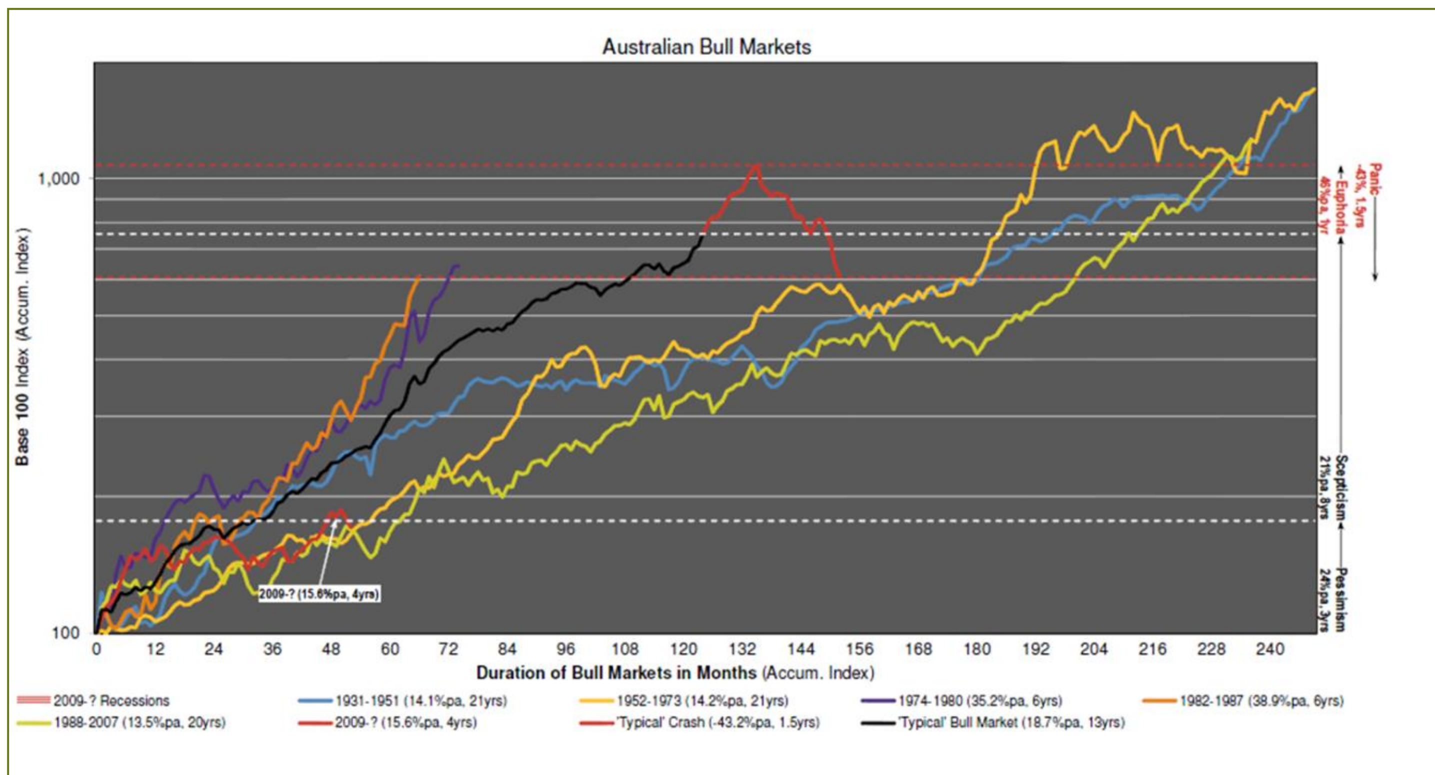
Portfolio Positioning

Fundamentally we think the Australian equity market is still moderately over-priced relative to our assessed fundamental value (-7%). Whilst the overall market is trading on a forward PE of 14.5x, the Industrials sector is trading on 18x, the highest in recent decades.

The recent uptick in capital markets activity, with an onslaught of IPOs and M&A deals, signals to us that it is a good sellers' market, particularly for the numerous private equity firms that are looking to divest many of their assets. The multiples that most of these businesses are being sold at are excessive in our view. This means that we need to be extremely selective at this juncture in the market as these IPOs are presented to us. This view is reaffirmed by our bottom up view on the value of the market.

We believe full year consensus 2014 and 2015 earnings forecasts of ~ +8% are overly optimistic, when compared to JCP's +1.4%. Consumer & business sentiment has weakened considerably in the past couple of months, with the Federal Budget a key driver. Sentiment at current levels is consistent with an acceleration in downgrades, especially from those sectors that are closer to the consumer, such as the retail sector and more specifically the discretionary end.

Despite concerns about the domestic economy, we are currently in an equity bull market and we remain structurally bullish on equities, however bull markets are punctuated by 10-15% corrections throughout history (see bull market chart below). We would argue that we are due (perhaps overdue) for one of these 10-15% corrections, especially given that we view the market as -7% expensive at present. Despite this short-medium term view, this structural bull market still has a long way to go, being only a third of the way through a typical bull market cycle.



The major overweight sectors for the portfolio are: Insurance, Consumer Services, Diversified Financials, Media, Materials and Energy.

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

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