JCP Investment Partners – June Quarter Outlook 2017

July 2017

At the end of the June quarter, the Australian equity market (All Ordinaries Price Index) was up +0.8% for the calendar year-to-date, having given back nearly all the gains for the calendar year (June quarter: -2.4%), with significant weakness occurring in May (-3.1%). Concerns over weakness in the domestic economy, saw consumer stocks and the banking sector underperform the broader market, resulting in the Australian equity market further de-coupling from offshore markets.

Offshore markets continued their strong outperformance over Australia, with the US markets (S&P500 +2.6%, Dow Jones +3.3% and NASDAQ +3.9%) registering their seventh consecutive quarter of positive returns. Japan was also stronger (Nikkei +5.9%), while markets in China (Shanghai Composite -0.9%) and the UK (FTSE -0.1%) were reasonably flat.

We continue to expect the Australian equity market to be flat in 2017, delivering a capital return of 0% (with a risk interval of +/-14% around this forecast), and an expectation that it will continue to underperform developed global equity markets. This flat return reflects our view that the Australian market overall is currently expensive. We also expect market conditions ahead to be less favourable as the US continues to normalise interest rates.

Australia

More evidence of pressures building

Following our March quarter outlook note, there have been many developments which have increased our conviction that pressures continue to build in the Australian economy, principally in the household sector. Some of these developments include:

1. More out of cycle rate rises

We were of the view in March that there would be a series of painful out of cycle rate increases to be absorbed by the Australian household sector.

Over the recent quarter, all the major Australian banks increased interest-only mortgage rates in response to APRA's 30% interest-only loan cap. Westpac reported their interest-only loans were 50% of their loan stock and 46% of their loan flow. ANZ and NAB were at 38% of stock and 43% of flow. Therefore, it was no surprise to see some measures introduced by APRA to curtail the growth in risky mortgages. Loans with a five-year interest-only term converting to principal and interest loans are resulting in a 30-40% rise in monthly payments on a typical mortgage! While this move should help bank margins in the short term (depending on the level of switching), such increases in mortgage payments hurt indebted households and will sooner or later impact banks asset quality.

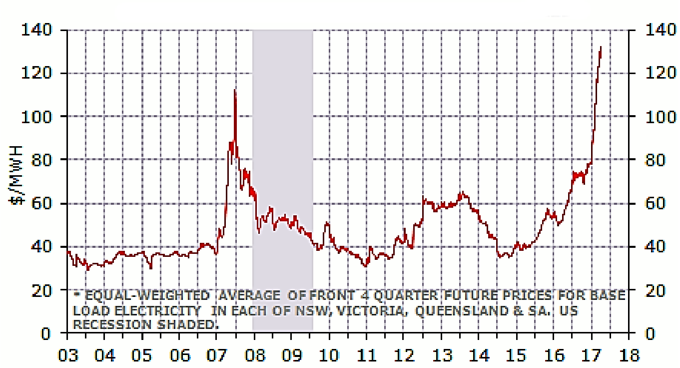
Rating agency Moody's recently downgraded Australian bank credit ratings due to the embedded risks in the housing market. Moody's cited significant house price appreciation in the core housing markets of Sydney and Melbourne has led to very high and rising household indebtedness.

Further out of cycle rate rises are not good for indebted households, which also have to contend with higher energy costs in 2017, and probably again in 2018 and 2019.

2. Higher energy costs

Significant volumes of contracted LNG exports are helping to lower global gas prices, but has radically increased the domestic Australian gas price. The marginal cost of domestic electricity generation is typically set by gas-fired generators; hence the rising price of gas has elevated Australian electricity prices. The chart below illustrates the future pricing for domestic base-load electricity in eastern states.

Australia Based Load Electricity Future Prices



Source: Minack

This pricing outlook will present further difficulties for the already income challenged, highly geared household sector, as they receive higher power bills in the second half of 2017 and beyond.

3. Macro-prudential regulation:

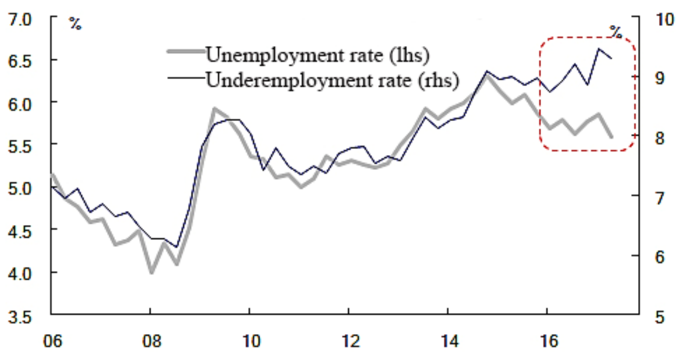
In addition to the caps on interest-only loans discussed above, we also suspect APRA will move for banks to have higher capital soon, which may see equity raisings take place (and possibly even further out of cycle rate rises). We expect two announcements from APRA: 1) defining "unquestionably strong" which will encompass capital, liquidity, funding and culture, and 2) higher product risk weights.

4. Consumers are dipping into their savings

The recent March quarter national accounts highlighted additional stress points. Household consumption rose by 0.7% in the quarter. This rise was not consistent with indicators such as retail sales, vehicle sales, and consumer confidence, which all pointed to negligible spending growth. Spending on services rose the most, such as electricity, insurance, operation of vehicles, and rent; reflecting unintended consumption, while spending on clothing and footwear went down.

Nominal household income continues to slow with year-ended wage inflation at 1.9%. A key reason for the lack of wage growth is the widening gap between unemployment and underemployment (defined as people who have a job, but say they want more work hours); illustrated in the chart below. The large shift to casual/part-time employment has meant household incomes have remained stagnant, while corporate profits have surged 16% y-o-y.

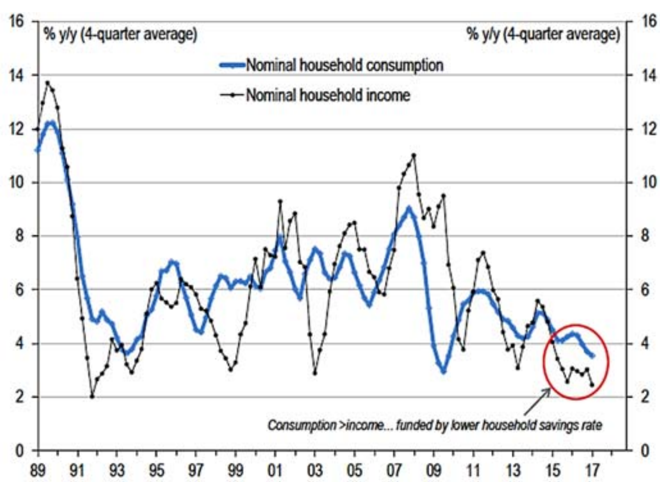
Australia - Unemployment and Underemployment



Source: Deutsche Bank

In response to weaker incomes and the higher costs of many essential services, the household savings rate has fallen to a new cyclical low of 4.7% of disposable income. The chart below illustrates household income is falling faster than consumption, seeing consumers draw down their savings.

Nominal Household Consumption and Income



Source: UBS

5. Residential building expected to fade, but non-mining and infrastructure will help:

We expect housing's contribution to growth in Australia will fade, evidenced by May's residential building approval data (-19% y-o-y), which has declined in annual terms for nine months, taking away one of the few sectors left of high pay jobs growth. There is some hope that non-mining and infrastructure investment may take up some of the slack. Recent proprietary meetings suggest a strong project pipeline, particularly rail infrastructure on the east coast. We are currently assessing some listed exposures to this thematic.

In summary, many of the pressures in the domestic economy discussed above are building, and may take some time to impact the economy; but when things do unravel, history tells us it will happen very quickly. Some pressures are already evident on discretionary household consumption. For example, the collapse of Top Shop, Marcs, David Lawrence, Herrigbone and Rhodes & Beckett, who have all gone into voluntary administration this year. Property developers and banks will also feel the impact of stretched household balance sheets and increased debt servicing commitments over the next couple of years. We remain happy being underweight those sectors exposed to these pressures, such as Retailing, Banks and Real Estate.

United States

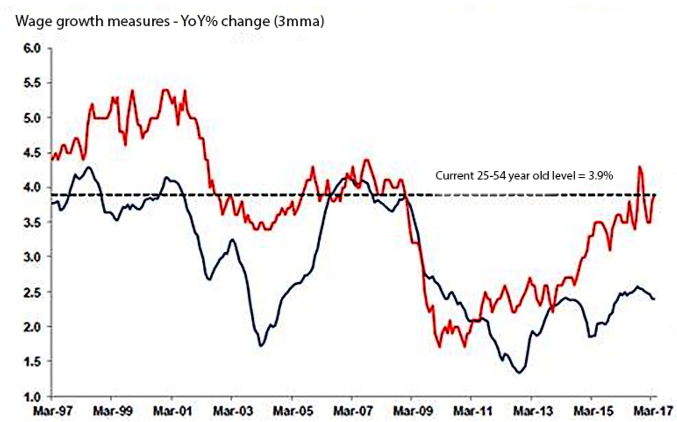
A better relative growth trajectory than Australia

Recent US macro data has been weaker than inflated post-election market expectations. The important consideration from a JCP perspective is that, in a relative sense, the US economy continues to demonstrate preferable exposure over the weakening Australian economy. From a portfolio perspective, we remain attracted to Australian listed companies that earn US Dollar cash flows, as we are encouraged that the US economy's growth trajectory is superior to Australia's.

1. Jobs growth continues to be strong

The US unemployment rate fell to a 17-year low of 4.3% in May, with average hourly earnings increasing by 0.2%, leaving the annual growth rate at 2.5%. While still strong, the pace of improvement in the US labour market has slowed, which is consistent with an economy approaching full employment. While the overall pace of wage growth has lagged market expectations, wage growth for 25–54-year-olds has already returned to prior expansion highs (see chart below) and may accelerate further if growth runs above trend.

Measures of US Wage Growth – YoY % change



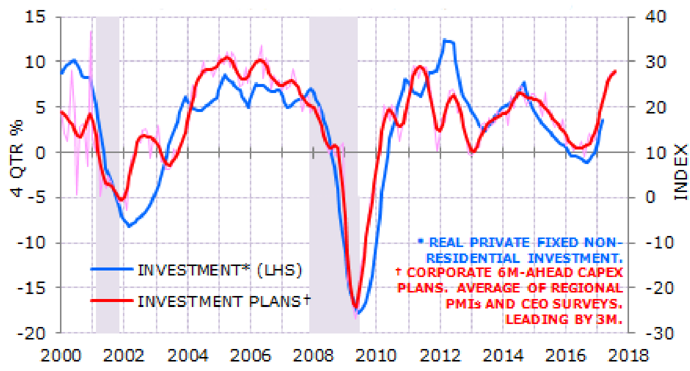
Source: Macquarie

Overall, real aggregate labour income is set to rise, partly because nominal wages are rising and partly because headline inflation will fall due to energy prices.

2. Corporate investment indicators remain elevated

Corporate investment indicators remain elevated, as illustrated in the chart below, pointing to stronger business investment in the second half of the year. Such investment has been the missing ingredient in the US recovery so far.

US – Real Business Investment & Investment Plans



Source: Minack

3. The rise in real yields points to higher rates globally

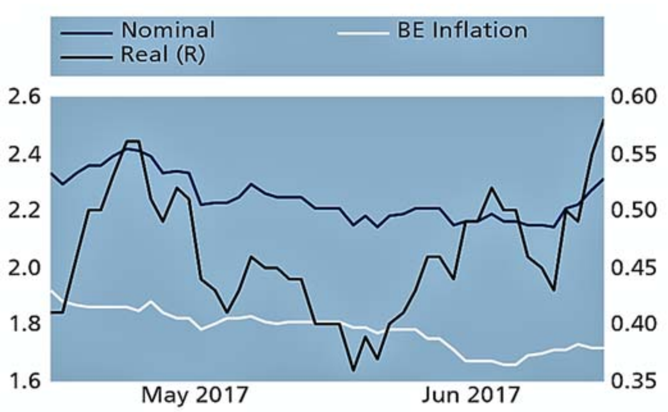
The US Fed pushed ahead with another rate rise during the recent quarter (their third increase in six months), outlining plans to tighten monetary policy despite growing concerns over weak inflation. The Fed also maintained their outlook for one more rate hike in 2017 and another three quarter-point rate increases in 2018; while also outlining plans to begin implementing a balance sheet normalisation program this year.

We interpret the Fed moves as a sign that they are happy with how the economy is tracking, and more importantly, that they believe in the growth trajectory.

Interestingly, the bond market does not share the Fed's optimism, neither on growth or inflation, particularly at the long end, given the interest rate forward curve has flattened. It may reflect recent inflation data undershooting relative to forward-looking indicators and a view that large-scale fiscal stimulus (which could exacerbate upside inflation risks), looks less likely due to political deadlocks.

The chart below shows US 10-year real rates in black on the right-hand axis, and the blue line is nominal rates on the left-hand axis. The white line (left-hand axis) is the difference; the so-called, break-even inflation.

US 10 Year Treasury Yields



Source: Lombard Research

Real rates have risen while nominal yields have not because some market participants are either happy with growth, which won't be inflationary; or that nominal rates continue to be suppressed by QE. Inflation and inflationary expectations have been lagging, partly caused by one off dis-inflationary forces, such as falling fuel prices.

JCP does not subscribe to the broader disinflationary view. Rather, the bond market continues to be impacted by QE. Our view is that money is worth a little more today than tomorrow in real terms and that nominal rates will follow as inflationary forces unfold.

Higher real yields reinforce our portfolio preference to avoid real estate stocks and have more US exposure. Rising real yields are indicative of increased capital expenditure by businesses and households, and indicate a positive view for increasing nominal rates in the future.

In summary, we expect the Fed will continue to hike interest rates even though trend employment growth has slowed and core inflation remains stubbornly below target. We continue to favour US exposed stocks in the portfolio versus Australian domestically exposed stocks. In this 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. Our portfolios are well positioned for this economic environment.

China

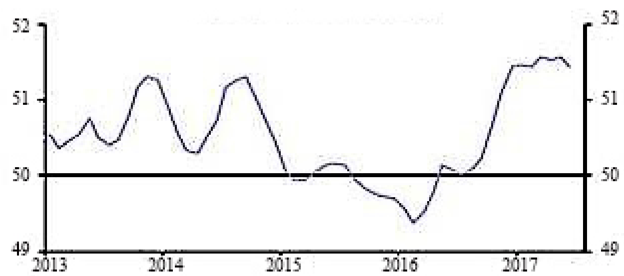
Recent policy response appropriate, but concerns over debt persist

JCP visited China in May and conducted a range of bottom-up meetings with private companies, SOEs, steel mills, metal traders, industry consultants, equipment manufacturers, construction and real estate companies.

Policy response to growth

We learned that the Chinese policy machine acted quickly last year to prevent a "hard" landing for China's economy, with huge amounts of credit being injected to improve demand. That support was extended into this year to help secure stable economic growth ahead of a transition in China's leadership. The provinces acted swiftly on Xi's supply side reform policies in coal (276-day policy) and steel (reduction of 100mt of capacity), pushing prices higher and companies back into profitability.

China – Official Manufacturing PMI (3m average)



Source: Capital Economics

Feedback suggested these developments led to a good recovery, illustrated in the manufacturing PMI chart above. There was an expectation however that conditions will slow in the second half of 2017 as headwinds from tighter money supply are expected to slow growth in parts of the economy before picking up again in 2018. The property market is expected to weaken in the second half, but infrastructure is expected to pick up the slack. Overall, our take from a range of meetings is that policy support with continue, particularly in infrastructure.

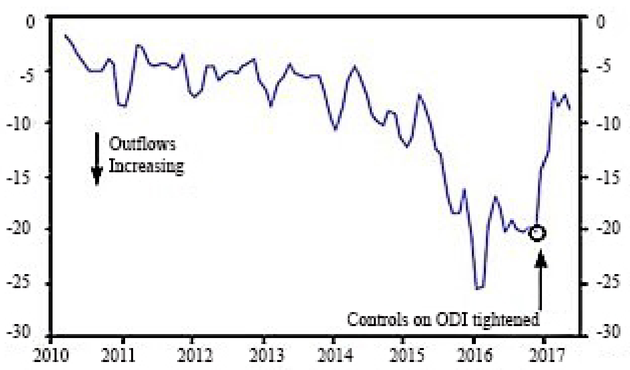
More recent data suggests that the second half slowdown is now underway, with slowing credit growth and tighter monetary policy impacting the economy. A tightening bias evidenced by a widening of measures to curb property speculation and increasing the cost of capital, is likely to impact commodities demand into 2H 2017.

The question for policymakers is how much of a slowdown in the economy they are willing to accept, particularly ahead of the November Communist Party Congress, when Xi is expected to consolidate power. Feedback from our meetings suggested that there were few obstacles to President Xi's reforms.

Capital Outflows

One area of concern JCP has had previously was China's ability to maintain capital within their economy, having experienced significant net outflows at the end of 2015, which exceeded $100bn per month. These net outflows have now substantially reduced as authorities have tightened capital controls, particularly the controls on outward direct investment late last year, which had a significant impact, as illustrated in the chart below.

China – Capital Flows due to Outward Direct Investment (3m average, $bn)



Source: Capital Economics

Time will tell whether these capital controls work in the medium term. We suspect that if the USD experiences a resurgence on the back of Fed tightening, hot money outflows from China will pick up again. The PBoC will be forced to consider whether it will allow the exchange rate (the price of money) to drop, or deposits (the quantity of money) to drop instead.

Debt concerns still mounting

The overall level of debt in China's economy is still concerning. Their ratio of credit to GDP has risen much further and faster than in any major emerging economy. The financial risks stemming from rapid credit growth are widely discussed, but the implications for the supply side of the economy, and the sustainable growth rate of the economy are of greater concern.

Moody's downgraded China's debt rating during the last quarter, warning about the risks associated with the accumulation of so much debt through China's government-led stimulus program that has been continuing for almost a decade.

The next twelve months will be critical in determining to what extent Beijing agrees with this risk assessment. Many small steps have been taken in the past six months, focused on deleveraging and de-risking the economy. Reducing capital outflows, improving information gathering in the banking sector, controls on mortgages, and restricting foreign investment are just some examples. Should Xi consolidate power, we expect the reform process to accelerate next year.

JCP research contacts and trusted commentators suggest if reforms do not continue, China's sustainable growth rate will slow rapidly, having negative implications for the Australian economy.

How all this plays out from an Australian equities perspective is important. Over the medium term, slowing Chinese credit growth and structural reforms are likely to impact Australian real estate, investment, trade, and tourism; resulting in some economic challenges. We would likely see an increase in Australia's risk premium, a substantial AUD fall, and a significant rise in our debt funding costs. We believe that the portfolio provides a good hedge against these real and present Chinese risks.

Portfolio Positioning

The portfolio continues to be 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, Media, Commercial Services & Supplies, Software & Services, Healthcare Equipment & Services, Energy and the Telecommunication Services sector**

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

Conclusion:

In summary, the pressures in the domestic economy discussed above are building and may take some time to impact the economy; but when things do unravel, history tells us it will happen very quickly. Some pressures are already evident on discretionary household consumption. Property developers and banks will also feel the impact of stretched household balance sheets and increased debt servicing commitments over the next couple of years. We continue to favour US exposed stocks in the portfolio versus Australian domestically exposed stocks. In this 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. Slowing Chinese credit growth and structural reforms are likely to impact Australian real estate, investment, trade, and tourism; resulting in some economic challenges. We would likely see an increase in Australia's risk premium, a substantial AUD fall, and a significant rise in our debt funding costs. We believe that the portfolio provides a good hedge against these real and present Chinese risks.

For further information, please contact:

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