JCP Investment Partners - June Quarter 2015

July 2015

At the end of the June quarter, the Australian equity market (All Ordinaries Price Index) is up a mere **1.2%** for the calendar year to date. Our market weakened during the June quarter by over 7%, giving back almost all the gains for the calendar year as concerns over Greece impacted markets late in June. The Australian market underperformed the US (S&P500 **-0.2%**) and Europe (MSCI **-4.5%**), impacted by a weaker Australian banking sector – which was plagued by increasing capital concerns and the potential for weaker earnings given the more subdued outlook for our domestic economy. Energy (**+0.8%**) and Telecoms (**-2.4%**) were the two best performing sectors for the quarter, whilst Financials [ex REITS] (**-10.4%**) and Consumer Staples (**-10.2%**) were the two worst performing.

As we suggested in our March quarter note, we expected the market to pull back at some stage later this year given the emerging weakness in the Australian economy, plus the fact that we thought the market was getting expense, i.e. our bottom up DCF valuation universe implied at the time that the market was 5% over-priced. Despite the equity market pullback we have seen, our valuation universe implies the market is still expensive, largely because of a rise in bond yields (the 10 year bond has risen from 2.31% to 3.01% over the quarter). We maintain our view for 2015 to be a year of fairly 'normal' capital growth for domestic equities and expect conditions to be less favourable once the US starts to normalise interest rates.

For some time now, policies have proved ineffective in preventing the build-up and collapse of hugely damaging financial imbalances, whether in advanced or in emerging market economies (EMEs). These have left long-lasting scars in the economic tissue, as they have sapped productivity and misallocated real resources across sectors over time. Low rates may in part have contributed to it by fuelling costly financial booms and busts. The result is too much debt, too little growth and excessively low interest rates.

United States

The US remains vitally important to our 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 for small, open, foreign capital dependent economies, such as Australia.

Overall, we remain positive on the US economy and view the impending change in the interest rate cycle as a sign that the economy is improving. In fact, if rates were to be held continually low for longer, we would view this as a sign that the economy is not on a sound footing. Interestingly, in a recent paper – "Is the unthinkable becoming routine?" (published in its Annual Report) - BIS suggests that extended periods of low interest rates cause the build-up and collapse of economically damaging financial imbalances that when unwound leave lasting economic scars by sapping productivity and misallocating real resources across sectors over time. Excessively low interest rates contribute to costly financial booms and busts, resulting from too much debt, and too little long-term productive growth.

The US labour market continues to show signs of improvement. US employers added 280,000 jobs to payrolls in May and the unemployment rate was steady at 5.5%. The Employment Cost Index, which is the broadest measure of labour costs, advanced 0.7% in the 1Q of this calendar year, which was the largest gain since the 3Q of 2014. In the 12 months to March, labour costs have increased 2.6%, which is the largest rise since the 4Q of 2008. This is below the 3% threshold needed to bring inflation closer to the Fed's 2% target, but wages growth should be 3% over the next year according to leading indicators, such as the percentage of companies planning to raise wages (see chart below).

Sources: Bloomberg, Deltec International Group

Importantly, wages growth was stronger across all private sector workers for the first 5 months of this calendar year, relative to previous years, as illustrated in the chart below. Additionally, job openings are also closer to an all-time high in the US according to the BLS JOLTS report.

Sources: Bloomberg, BLS, Macquarie Research, June 2015

For an economy largely built on consumption these are undoubtedly good signs. The 30%+ fall in gasoline prices over the last year should also boost real incomes by 1-2%, which when added to 2% nominal growth equates to 4% overall growth in incomes, which is the strongest in 7 years. Unless US consumers save this real income boost (which they did in the 1Q 2015), then we would expect that recent increases in consumer confidence should lead to an increase in retail sales and consumption.

The missing link in the US remains productivity growth, which is the lowest in 20 years. Also there are no clear signs yet of improvement in the business capex cycle despite companies having cut capex spending for the past decade.

As we approach a likely turning point in the US interest rate cycle, our challenge is to ensure the portfolio is positively exposed to companies that are relatively insensitive to higher interest rates, whilst avoiding companies that are negatively impacted by higher rates.

Given the improvement in the underlying economy, we expect the Fed will tighten later this year, but the uncertainty in the Eurozone may push the Fed's first rate increase into early next year. We also expect the pace of subsequent hikes will be measured and the tightening cycle to unfold more slowly than in previous cycles.

Therefore, we continue to favour companies leveraged to the US economy and a strengthening US dollar.

China

We continue to 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, we observe that as the transition from the old to the new economy continues, it becomes increasingly difficult, especially in more politically sensitive areas such as increasing competition in important industries and privatisation of State Owned Enterprises.

Given the 'rocky' transition process, the PBOC has cut the lending rate to a record low – recently cutting rates for the fourth time since November last year (with the one year lending rate being cut by 25bps to 4.85% on June 28). In one of the starkest official warnings about China's growing debt woes, the PBOC said in its Monetary Policy Report that the "rising debt size is forcing China to use a lot of resources in repaying and rolling over debt", whilst limiting the scope for further fiscal expansion.

Further efforts to stimulate the economy seem to be required given recent trade data which suggested that foreign and domestic demand had softened in 2Q2015. Additionally, the slowdown in manufacturing FAI over the last year is further evidence of a weakening in the Chinese economy.

Overall though, our sense is that the Chinese economy, with its large domestic savings pool and negligent dependence on foreign capital inflows, can avoid a hard landing scenario in the short to medium term. However, the misallocation of resources and lower productivity dividend that comes from each debt-fuelled stimulus package will one day bring a 'day of reckoning' in the form of structurally slower growth in the medium to long term. The short-term risk to our view is that slower growth becomes politically destabilising and that the Communist Government 'hits the accelerator again' with an oversized stimulus package aimed at significantly increasing fixed asset investment, but we see this as a low probability outcome.

China's transition from an investment to a consumption led economy presents enormous challenges for the Australian economy given the associated decline in demand for iron ore and coal, and consequentially the prices of these commodities. It is possible that China attempts to hold up growth in its commodity intensive sectors to prevent further slowing of their economy. This would mean that commodity intensive demand would bottom sometime this year, with the government likely to stimulate property and infrastructure volumes if demand in China's industrial, property and manufacturing sectors continues to fall. However, new construction volumes in the property sector are still some time away given the housing inventory overhang in China. We forecast that "peak steel" in China is occurring this year, and whilst commodity prices may stabilise, given that many are close to or below our long run forecasts, iron ore is exposed to more downside risks given the excess supply coming over the next year or so.

From a portfolio perspective, we have been reducing our exposure to the materials sector in recognition of the increased supply ahead at a time when we expect demand to soften. In the short term, the iron ore price has rallied given the limited new supply coming on over the past 4-5 months, and poor weather impacting production ramp-up at some RIO mines. This has also corresponded with a period where Chinese steel mills have been restocking. As we get into the second half of 2015 we see supply picking up again (particularly from RIO as their 360 project starts delivering) at a time where there is underlying poor end user demand. As such we have been happy to reduce our weight in BHP and RIO over the last few months.

Europe

Prior to the Greek events unfolding late in the June quarter, economic stabilisation in Europe was slowly turning into recovery. The manufacturing PMI has been increasing since November 2014, assisted by a lower Euro. This lower Euro will to continue to support the manufacturing sector going forward, and boost exports from the region.

Unemployment has been declining (albeit slowly), and lending standards have been easing – resulting in the strongest demand for loans since the GFC. Also, retail sales growth is at the highest level since 2007 (see chart below).

Sources: Bloomberg, Deltec International Group

In the event that Greece is unable to reach an agreement with the European Commission and IMF over the coming weeks, we expect that the implications of a Greek exit from the Eurozone would be further weakness of the Euro, (relative to the US$ and $A), plus broad strength in US$ flows into US treasuries/bonds. This may result in the US Fed delaying increasing rates.

In regards to contagion risk for European banks from the fallout of Greece, this is expected to be fairly low. Most Greek debt is now held by the IMF, ECB, or via EU funding vehicles. The possibility

of a Greek exit from the Eurozone has been discussed for many years. At JCP, we first wrote about it in January 2011: jcpip.com.au/docs/jcp-investing-in-practice-market-outlook-2011.pdf

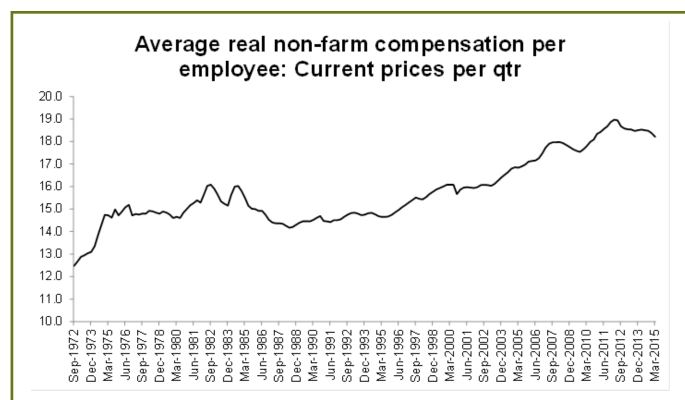
From an Australian equities perspective, the Greek events create a short term hit to confidence for our market, which may push down bond yields as people seek 'safe haven' investments, but we think that contagion risk is pretty limited so any impact of a Greek exit should have a limited impact on markets over the medium term. To the extent that we continue to see a broad-based sell off, we will take advantage of stocks trading at discounts to their valuations, and use any weakness as a buying opportunity.

Australia

Many structural weaknesses still exist in the Australian economy which will create formidable economic headwinds as we move forward.

Our key area of concern is that income growth continues to slow. Despite a stronger headline GDP print last quarter (real GDP rose 0.9% q/q in Q1), the year-on-year pace of economic growth continued to move lower. A strong consumption contribution, and strong dwellings were offset largely by weaker capex. Real gross domestic income edged up only 0.2% q/q, falling negative year on year (-0.2%) for the first time in 2½ years, with employee compensation up just +0.1%, or -0.35% per capita in the quarter. Consumption continued to grow, which meant that the JCP calculated cash savings rate (which deducts imputed rents and interest on superannuation holdings) continued to fall quite quickly.

The likelihood of a recession in Australia continues to increase, driven by declining terms of trade, ongoing weak non-dwelling investment, and a flattening out of dwelling investment. Recent employment data has been volatile, and there have been problems with the Bureau of Statistics' survey. Average compensation per non-farm worker (which captures shifting hours worked and industry mix) continues to fall (see chart below). Consequently, household income growth is relatively muted despite solid jobs growth. So in summary, our economy is providing less income, and the economic downturn continues to accelerate.



Source: JCP Investment Partners

Another key area of concern is that the domestic interest rate easing cycle may be nearing an end as the US approaches its first rate hike. Because Australia is a small, open, foreign capital dependent, economy, the trajectory of US interest rates largely determines the interest rate cycles for our economy, albeit with a lag. This has been reflected in Australian long-term bond yields recently moving higher with US bond yields.

The level of household indebtedness in Australia, combined with weaker national income presents problems for our domestic economy when rates start to eventually rise. Given that building approvals are at all-time highs (creating more supply), it's no surprise that APRA are specifically targeting a slowdown in property price appreciation.

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.

Portfolio Positioning

The portfolio remains positioned for two key themes:

1. **Weakness in the domestic economy** – having little or no exposure to the Banks and Retailers.
2. **An improvement in the US economy** (and a strengthening in the US Dollar)

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

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

Conclusion

Our conviction on the current positioning of the portfolio remains stronger than ever. The portfolio is 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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