JCP Investment Partners - March Quarter 2015

April 2015

At the end of the March quarter, the Australian equity market (All Ordinaries Price Index) is up 8.8% for the calendar year to date. Our market performed strongly in line with most markets globally, (the US S&P500 (+0.4%), Europe MSCI (+15.9%) and Japan (+10.1%)), boosted by a more accommodating monetary policy stance, as the RBA cut interest rates by 25bps in February with an expectation of further rate cuts to come. Banks & Financials ex-REITs and Consumer Discretionary were the two best performing sectors for the quarter, whilst Energy and Consumer Staples were the two worst performing.

The strength of the market so far this year has been beyond our expectations. We would expect the market to pull back at some stage later this year given the emerging weakness within the domestic economy plus our bottom up DCF valuation universe now implies the market is slightly expensive (-5%). We expect 2015 to be a year of fairly 'normal' capital growth for equities and expect conditions to be less favourable once the US starts to normalise interest rates.

United States

The US remains 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.

We remain positive on the US economy and continue to favour US economic exposure in the portfolio. However some of our US exposed stocks are now starting to look fully valued.

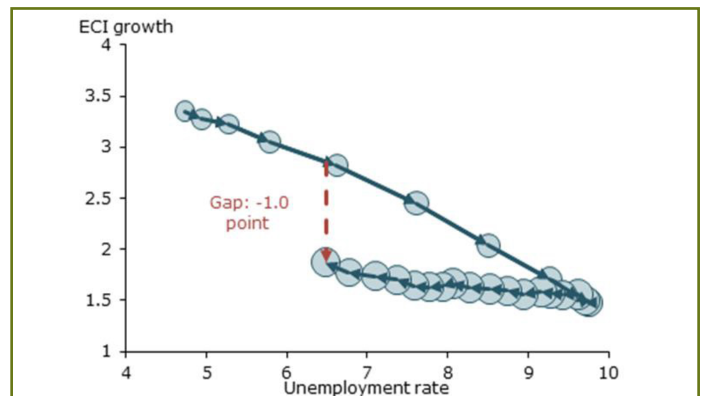
The US labour market continues to show signs of improvement. US employers added 295,000 jobs to payrolls in February and the unemployment rate fell to 5.5%. While the economy has steadily added jobs and the unemployment rate has declined, wage growth still remains modest. In February average hourly earnings increased 2% from a year earlier, a slower pace than in January.

Steven Semczyszyn (JCP's Head of Portfolio Management) recently travelled through the US, which reinforced our view that the US consumer is improving. However, feedback from company meetings was that there are no signs of a capex cycle and the oil states are yet to feel the pain from lower oil prices. Also there were no obvious signs of wage inflation, but this tended to be industry specific, and there were exceptions such as Walmart and Target who have increased the minimum wage from $8.50 to $10. The trucking industry ("where they've been underpaid for too long") is also experiencing some wage growth. As a rule, those industries that have been underpaying for a long time are now experiencing some catch-up, but wage inflation is not broad based.

This is an important area to keep an eye on given the US economy is largely built on consumption and for the recovery to go to the next level, broad based wage growth needs to occur. It is likely that wages could be kept lower for longer due to increased participation. Research by the Chicago Fed suggests that the natural rate of unemployment (the rate where wages start to accelerate) may be as low as 4.5%. If that's correct, then wage growth may flat line for the remainder of this year, and no growth in wages probably means interest rates are held lower for longer.

This vexing issue of slower than expected wage growth is clearly shown in the chart below produced by the Federal Reserve Bank of San Francisco. The chart plots the quarterly change in the Employment Cost Index (ECI) versus the unemployment rate since 2008. "The first part of the curve shows the behaviour of wage growth and the unemployment rate during the recession, when the unemployment rate increased by about 5 percentage points and wage growth slowed by about 2 percentage points. The second part of the curve shows that during the subsequent recovery wage growth did not increase as much as it declined during the downturn. The result is that the most recent reported wage growth was 1 percentage point lower than it was at the same level of the unemployment rate when unemployment was rising."

US Wage Phillips Curve for All Civilian Workers, 2008–14



Source: FRBSF Economic Letter

This gap is critical for monetary policy because wage growth is the key to nominal economic growth, and the outlook for interest rates. Various suggestions such as wage rigidity in particular industries, or a change in the natural rate of unemployment, have been suggested as drivers of the difference. It is interesting to note that the finance, insurance and real estate industries haven't suffered the same fate, although they arguably started from a lower level.

The Fed effectively pushed out expectations for a hike in rates late in the March quarter. This is in line with our view that we had previously expected 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).

We expect the Fed will tighten only when it is sure that the economy is on a sound footing. As such, equities should not be hampered by rising rates in the short term.From a portfolio perspective, we continue to favour companies leveraged to the US economy and a strengthening US dollar despite some US exposed stocks nearing full value.

China

As we wrote in our January outlook note, there are two ways we think about China: (1) impacts on 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 to soften the economic impacts as the reform process continues.

Given the rocky nature of this transition, the Government and the People's Bank of China (PBoC) in recent months has introduced significant stimulus measures. The recent PMI data suggests growth is faltering, with a slowdown in Q1. A sharp fall in the new orders component of the PMI, from 51.2 to 49.3, was the biggest factor behind the drop in the headline index, which appears to reflect weaker domestic demand.

Efforts to rectify this are now underway, with significant boosts to the property market recently announced, e.g. the down-payment requirement for second home mortgages has been lowered to 40% (from 60%). This policy change is meant to help stabilise economic growth since the housing correction has continued to be seen as one of the key drags on domestic demand growth this year, with home sales falling 17.8% on the previous corresponding period. We continue to have significant concerns regarding the sustainability of property supply, particularly given declining property demand and falling property prices.

External demand is likely to improve as US and European consumption recovers, but China's competitive position is being undermined by the stronger real FX rate. Overall, we continue to believe that an economic hard landing can be avoided. However, it is clear that growth will be structurally slower moving forward and likely to fall to a level closer to 4% over the next few years.

In assessing China from an Australian economic perspective, we forecast that "peak steel" in China is occuring now. This presents an enormous challenge for the Australian economy given the associated decline in demand for iron ore and coal, and the prices of these commodities. We doubt a turnaround is likely in the short term given that fixed asset investment growth has been slowing for the past 12 months, and is likely to continue to do so. For iron ore producers, the key will be how quickly high cost supply is mothballed, and the stabilisation of growth in the non-construction industry drivers of steel demand.

From a portfolio perspective, we are happy to maintain exposure to the lowest cost producers of iron ore that stand to benefit as their lower cost volume expansion displaces the higher cost producer. These companies still have strong free cash flow growth, despite lower commodity prices, as a result of increased volumes and significantly lower capital and operating costs. Because of these strong cash flows, capital management is now a major focus for these large cap miners.

Europe

The launch of full blown QE by the ECB to fend off deflation has been successful to date. QE has led to stronger European equity markets with large equity flows into Europe. Negative bond yields in Europe have seen debt flows move to the US in search of higher yields, putting upward pressure on the US Dollar. QE has also pushed down the Euro, boosting export growth, with Germany being the largest beneficiary.

These developments, along with the weaker oil price, could lead to upside risk to European GDP growth figures, meaning that the worst of the fiscal austerity measures could be behind them.

The reality is that we will not know if the large QE experiment in Europe has worked for some time. The gap between the real economy and the financial economy is still large and a low growth environment for the foreseeable future is the most likely course. From a portfolio perspective we remain cautious on companies with Eurozone exposure.

Australia

In our January note we wrote about the many structural weaknesses in the Australian economy which will create formidable economic headwinds in 2015 and beyond.

Some of these structural imbalances, such as too much debt in the household sector, and a structural deficit that is too high, are worse today than when we wrote about them in January. In regards to household debt, February was the biggest month for housing mortgage applications so far in this cycle. According to CBA data, the number of housing applications for established property jumped 36% in the month, while the value jumped 47%.

Much of this increase has been driven by demand for interest only loans, meaning the household sector is now even more prone to the risks of declining house prices and/or rising interest rates. These risks may not hurt the economy in the short term, because of probable further interest rates cuts as the economy continues to weaken, but in the longer term this high level of debt makes the Australian economy extremely vulnerable to economic shocks.

According to a recent paper by McKinsey Global Institute, Australia now has a larger household debt ratio than existed in the United States or the United Kingdom at the peak of their credit bubble. McKinsey also believe that Australia is one of seven economies globally that have potential vulnerabilities owing to the high levels of household debt. Of the seven countries listed, two have large domestic savings pools (China and Germany); one has a reserve currency and is seen as a 'safe haven' in periods of economic turmoil (United States); three run large current account surpluses (China, Germany, and South Korea); and two run current account deficits, are dependent of foreign capital flows, and are going through large negative terms of trade shocks [Canada and Australia].

Against our ever increasing household indebtedness, much has been made of Australia's currently high household savings ratio despite it only reflecting a return to historic levels. We suspect that the published savings rate overstates the flexibility it implies in the event of an economic shock.

JCP uses ABS National Accounts Household Income and Expenditure to calculate a 'cash version' of income and saving. This removes, amongst other things, the 'imputed rent' from income along with other transfers to non-incorporated, non-household entities. It also removes imputed interest in superannuation funds. We are seeking to remove items which can't assist households in periods of economic weakness.

This 'cash savings rate' (from which interest still needs to be deducted) is shown in the chart on the following page (the black line). The 'post interest paid cash saving rate ratio' is also shown on the chart (the blue line).

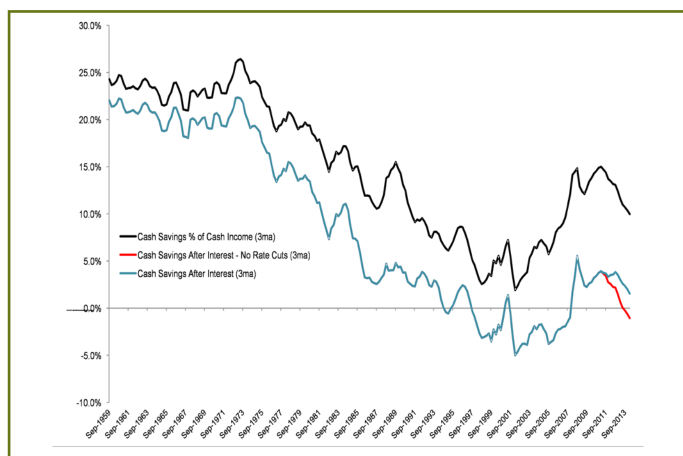
The 'cash savings rate pre interest costs' began to pick up in the early 2000's before peaking around the time of the stimulus

packages during the GFC. Post interest it remained negative until fiscal stimulus and interest rate cuts in 2008.

Note that the 'pre-interest savings rate' has been falling since 2011, and only successive interest rate cuts have kept the 'post interest saving rate' from falling below zero again. The red line on the chart shows (ceteris paribus) what the 'post interest cash savings rate' would have been if the interest rate cuts hadn't occurred, and is indicative of the trajectory of this important measure of savings once rate cuts are exhausted and as household debt continues to rise.

Our concern is that the Australian economy is in a far more precarious position than it was the last time the 'cash savings rate' was negative. Our terms of trade are declining, the unemployment rate is rising, and arguably the number of interest rates cuts remaining is limited by rising US interest in the near future.

Household Cash Savings % of Income Before & After Interest



Source: FRBSF Economic Letter

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.

Reporting Season Wrap

While reporting season passed with relatively few surprises from JCP's perspective, share price volatility was notably higher. Cost cutting continued to be the major theme as a distinct lack of top-line growth was again evident across much of the market.

This weakness in revenue saw 55% of companies report a decline in margins. More margin contraction can be expected in the period ahead unless the revenue environment improves. The relentless effort to cut costs can assist individual companies boost margins, but such is the 'paradox of thrift' – if most companies are cutting costs, unemployment rises, consumer confidence and spending fall, and revenue growth therefore is harder to achieve.

Whilst many industrial companies have been cost cutting for some years now and are arguably getting towards the end of this process, the resources sector has only just begun a decade long cost out program, and as such have delivered a material decline in cost growth during this reporting season.

Capital management was another strong theme throughout reporting season, most notably with Rio Tinto announcing a $500m off-market buyback, and Tabcorp's capital raising to fund a special dividend to distribute excess franking credits.

Portfolio Positioning

The portfolio remains positioned for three 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) – exposure to QBE, FOX, RMD, CSL, NWS, WFD, BXB.
3. **A structural slowdown in China** (rather than a 'hard landing') – exposure to the lowest cost producers of bulk commodities.

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

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