JCP Investment Partners – March Quarter Outlook 2017

April 2017

At the end of the March quarter, the Australian equity market (All Ordinaries Price Index) was up 3.2% for the calendar year-to-date. After a weak start in January, markets rallied strongly throughout February and into March, posting a solid gain of 2.5% for the month of March.

US markets were the clear outperformers (S&P500 +5.5%, Dow Jones +4.6% and NASDAQ +9.8%), inspired by the pro-growth Trump policies and rhetoric. The Australian equity market underperformed the US, however, performed better than the UK (FTSE +2.5%) and Japan (Nikkei -1.1%). 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 underperform 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 the first quarter of 2017. We expect the Trump-inspired rally may lose some momentum given the Republicans recent failure on healthcare reform, which may imply delays around tax reform. We also expect market conditions ahead to be less favourable as the US continues to normalise interest rates.

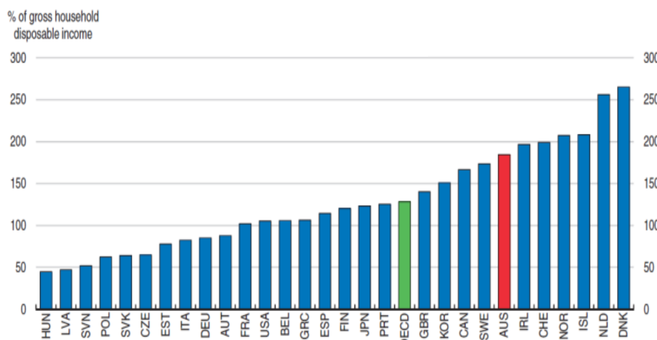
Australia

The pressures are building

At JCP, we have long written about the vulnerabilities of the Australian economy, specifically focused on the risks of a housing market slowdown given high levels of household debt, rising global interest rates and record low wages growth to support these extremely high debt levels. Admittedly, we have been very early to observe and write about these risks, however as we sit here today, we strongly believe that these issues are becoming more mainstream and it is very clear that these **pressures are building**.

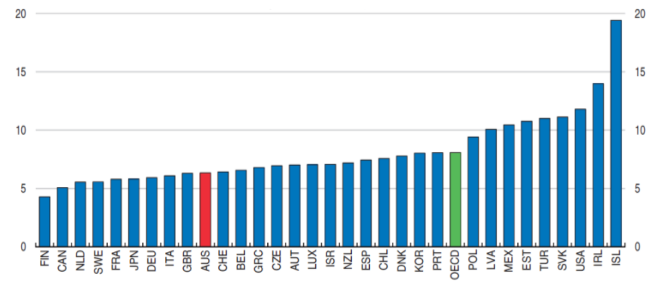
The release of the OECD's *Economic Survey of Australia 2017* has fuelled this ongoing debate about Australia's economic vulnerability. Our view is that it will be worse than implied by the OECD Report given the vulnerability of Australia's banking system. The charts below clearly illustrate this vulnerability. The first chart shows Australia sits in the 8th decile of household sector leverage in the OECD, while the second chart shows Australian banks sit only in the 3rd decile of bank capital to assets.

Australia – Household debt



Source: Australia 2017 OECD economic survey

Australia – Bank capital to assets ratio



Source: Australia 2017 OECD economic survey

The risks to the Australian banking sector are obvious from the charts above. Complicating these risks for the banks is household discretionary cash flow continues to deteriorate, partly on the back of the rising cost of living and anaemic wage inflation, but also partly because of rising mortgage payments.

Why are we confident that the pressures are building?

1. *Out of cycle rate rises have already begun:*

We have written previously that in an environment of global rising interest rates, Australian Banks would be forced to pass on higher rates due to their cost of funding increasing. Australia remains a small open economy, which is highly dependent upon foreign capital to fund accumulated current account deficits. The major Australian banks derive up to 40% of their funding for loans from offshore money markets. The cost of this funding is rising given the US, and the global economy, are improving, and global money markets are factoring in higher bond yields. This higher cost of funding is now beginning to be passed through to the Australian household sector in the form of out of cycle rate rises, irrespective of what the RBA does with monetary policy.

We are of the view that the recent round of out of cycle rate rises by the major Australian banks is only the beginning of what will be a series of painful rates increases to be absorbed by the Australian household sector. As the US economy continues its growth trajectory, global rates will head higher, resulting in even higher funding costs for Australian banks. RBA monetary policy is being curtailed by weak household income on the one hand, and rising house prices and household debt on the other, complicated by rising global interest rates.

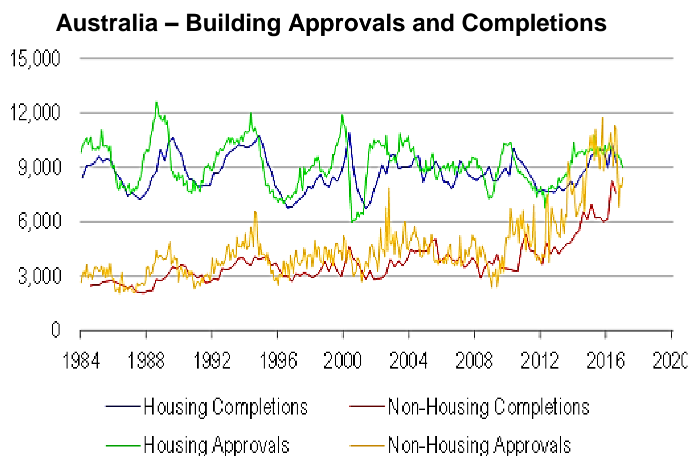
2. *Macro-prudential regulation:*

APRA is acutely aware of these risks, having stepped in with macro-prudential policies to slow the momentum in the housing market. APRA will keep the 10% investor cap in place while also capping interest-only loans at 30% of new business (versus 40% of existing loan stock). We are sceptical about the effectiveness of such macroeconomic policies in such a low rate environment, believing that continued out of cycle rates rises will have a greater impact over time. We also find it ironic that the RBA expressed disdain for such policies only a few years ago.

3. Building approvals starting to trend lower:

Time will tell whether we see an orderly unwinding of the housing market or a more dramatic and painful collapse. One area we are watching is the cycle in residential construction activity. The approvals cycle in annual trend terms continues to ease lower, and given the amount of stock in the pipeline, we remain wary that a portion of the building applications approved to date does not evolve into actual construction.

Australia – Building Approvals and Completions



Source: Credit Suisse

4. Record low wages growth:

The record low wages growth in Australia has long been central to our thesis of a weakening domestic economy, particularly when combined with high household debt levels. Wages growth remained soft in 4Q16, up only 0.5%, while in annual terms, wage growth remained at a historical low of +1.9%yoy. Wages weakness is mainly in the private sector (+0.4%qoq, +1.8%yoy), which is also where the household debt problem exists.

Despite record low wages, consumption was up 3.5%yoy in the 4Q, partly funded by savings, which has taken the savings rate down to 5.2% in 4Q16 (down from a peak of 10% in FY12). Retail Sales have begun to weaken, with nominal retail sales below market expectations in February, falling by 0.1% and year-ended growth slowing to 2.7% from 3%. Excluding food, the weakness was even greater, with nominal sales falling by 0.4% in February.

5. Proprietary research points to stress points:

JCP is undertaking some additional proprietary research in this area, specifically focused on the household sector and their ability to service borrowings. Greg Medcraft (the Chairman of ASIC) recently spoke to affordability issues amongst certain cohorts of the Australian population. Our analysis suggests that there are certain segments, such as *Millennials* and *Young Affluent*, that are extremely debt-stressed. These people don't have enough money to cover their loans if rates move higher and will most likely be selling properties with negative equity if house prices weaken in the near term.

At present, dwelling prices in Australia remain very high; recording a +1.4%mom gain in March 2017, +3.5%qoq, and thus taking the annual growth rate to a new cyclical high of +12.9%yoy; which is the highest annual price appreciation rate in seven years. This momentum hides the vulnerabilities discussed above.

However, we strongly feel all the pressures are building in the Australian economy, and it is only a matter of time before these pressures start to bite.

In summary, companies exposed to a highly indebted Australian household sector (e.g. property developers, discretionary retailers, retail-focused REITs, commercial banks, etc.) will begin to 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 continue to slow significantly and turn into strong headwinds as we experience more upward pressures on interest rates.

United States

Remain bullish on the US economy

We began 2017 with a bullish US economic outlook supported by the unique promise of fiscal largesse to stimulate nominal growth, a reformist agenda to unpick secular stagnation, and tax cuts to benefit the corporate and household bottom line.

At the end of Q1, the market is right to reassess the capacity of the Trump administration to deliver its reforms, given the complexities of implementing such policies. We sense the rally is too extended, given corporate tax cuts alone aren't sufficient, so a small correction is possible and may provide a good buying opportunity as we remain bullish over the medium term.

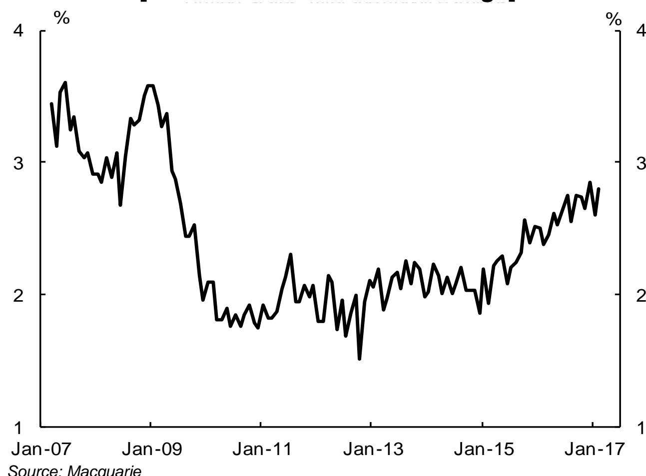
The US continues to have the preconditions, including a US Federal Reserve slightly behind the curve, to benefit from policies that promote internal investment, favour domestic consumption and seek to rebuild infrastructure. The Trump rally to date is symptomatic of a global system refocusing towards nominal growth - a great outcome for equities in the medium term.

We are encouraged that the US economy is strengthening on several fronts:

1. Stronger employment market:

Job growth in the US continues to be very strong, recording a 235,000 gain in non-farm payrolls in February, on top of a 227,000 gain in January. Despite these strong figures, the official unemployment rate has only fallen slightly to 4.7% (from 4.8% previously) because more people are now seeking employment (reaching the highest level since February 2009). Average hourly earnings increased by 0.2%mom in February and, thanks to an upward revision to the gain in January the annual growth rate rebounded to 2.8% last month (from 2.6% previously).

US – Average Hourly Earnings
[Private sector % annual change]



Source: Macquarie

The strength in the employment market clearly gave the Fed the confidence to lift rates again in March. We expect to see further rate increases later this year (probably another two rate rises), particularly if the tax cuts proposal passes through the US Congress later this year.

2. *Fiscal expansion and tax cuts have a major role to play:*

Assuming the Trump administration can win support from Congress, the combination of tax cuts and border-adjusted tariffs will likely benefit American businesses. Also, a middle-class tax cut to offset higher imported prices from a Border Adjustment Tax is sensible and should gain Congressional support.

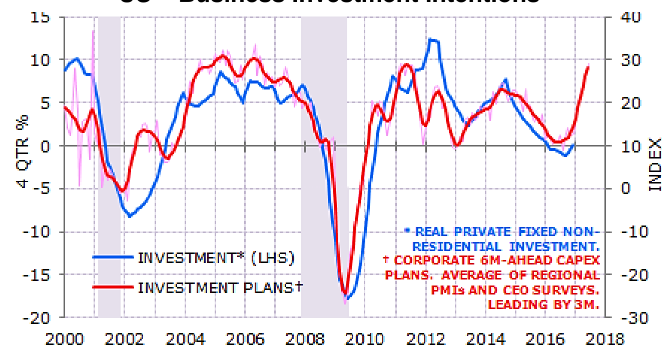
The planned US$1 trillion investment in infrastructure represents around 5.5% of nominal GDP. The timing of these spending proposals and tax cuts will hit a US economy running close to full employment and so will significantly boost nominal US growth. This backdrop will increase the likelihood of further rate normalisation by the Fed eventually back to 2.5-3.0% over the next couple of years.

3. *A pick-up in business investment:*

Business investment has been the missing ingredient in the US recovery to date. The prospect of lower corporate taxes and reduced regulation should combine to revive the corporate sector's 'animal spirit' and thus their willingness to invest.

Such actions will improve the supply side of the economy, helping to suppress the cyclical pressures on inflation, and ensuring the economic up-cycle can run for longer. Importantly, business investment intention surveys point to an improved investment spending outlook (see following chart).

US – Business Investment Intentions



Source: Minack

Also, non-defence capital goods orders excluding aircraft (which are a good proxy for capital spending) have experienced a recent bounce; rising for three consecutive months. Over the last six months, core orders have increased nearly 7% annualised. With corporate tax reform on its way and with other investment incentives for businesses likely to be implemented (such as full expensing of capital outlays) the overall trend in investment spending is poised to strengthen significantly over the quarters ahead.

There are clearly risks that remain in place, particularly regarding a possible rise in geopolitical tensions with China, continued uncertainty regarding trade policy, and the way the new administration seeks to 'jump-start' the US economy with fiscal, taxation, and other legislative initiatives. However, the fundamentals of the US economy are strong, and this strength should continue in the next couple of years.

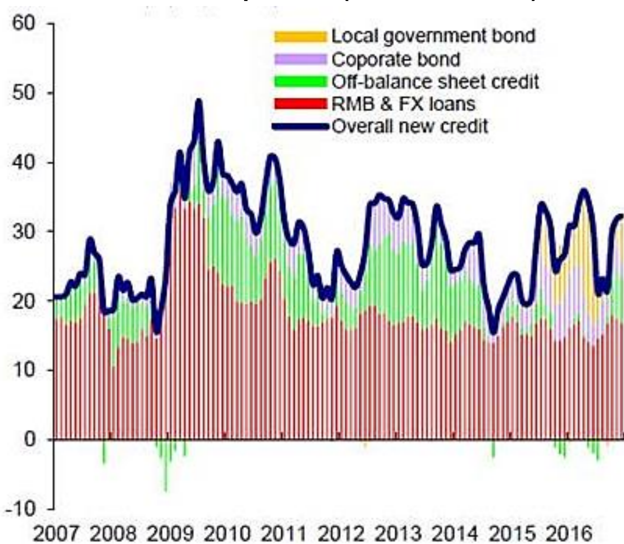
The Trump rally to date is symptomatic of a global system refocusing towards higher nominal growth (with some ongoing financial repression), which should be a great outcome for equities in the medium term. In this type of environment, having exposure to USD earners, minimising exposure to bond proxies, 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 focus.

China

Remain cautious given continued credit expansion. China has demonstrated a willingness to commit to growth via continued significant credit expansion. The Chinese Premier presented the 2017 government work plan, which was not designed to be bold, but to ensure stability for the critical leadership transition year. Despite being portrayed as a pro-reform plan with a slower GDP target of around 6.5%, the fixed asset investment growth target was kept high at 9%pa (an increase from last year's 8%).

Clearly, statements promoting stronger growth and stabilisation in the RMB has resulted in positive sentiment towards China over the last quarter. Our cautious stance on China revolves around the extraordinary amount of credit growth China unleashed to ensure their economy maintains consistently high growth levels. The chart below illustrates how China had to go "back to the well" of increasing credit by >30% of GDP to maintain high GDP growth. Each time with support from new and 'interesting' sources of credit!

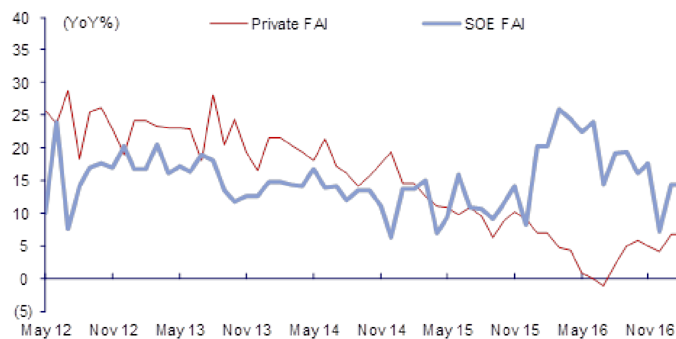
China – Credit Expansion (Share of GDP %)



Source: UBS

When credit growth fell back to only +20%, the Chinese economy slowed discernibly, requiring credit to be pumped back into the economy to stabilise growth. The charts below show the historical allocation of credit.

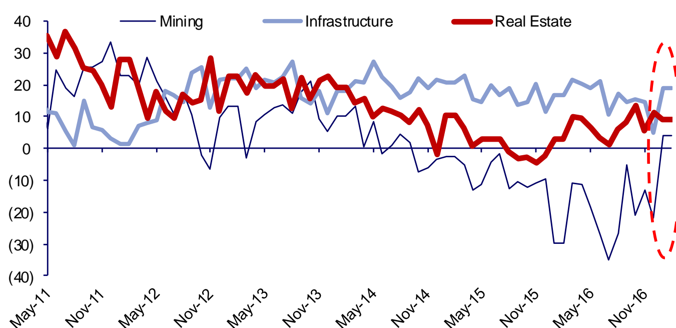
China – Fixed Asset Investment (FAI)



Source: CLSA

Significant SOE credit expansion took place through early 2016 (via local government bonds) to offset the waning private FAI. However, when the private sector was sure that credit availability had returned, they too grew again. As illustrated in the chart below, Chinese credit has been mainly directed towards Mining and Infrastructure.

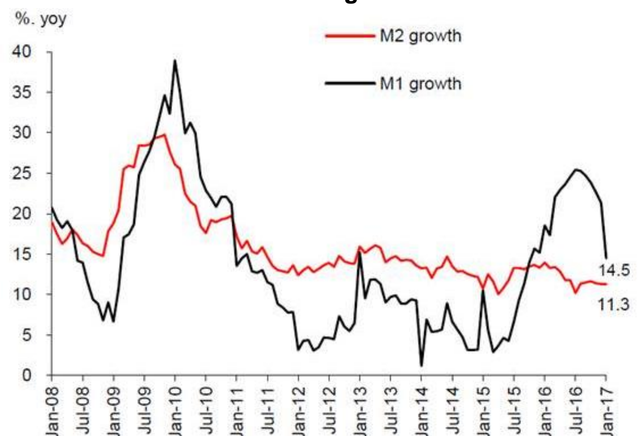
China – Investment Sectors



Source: CLSA

Extra liquidity was added aggressively to the Chinese economy in late 2015 and also through 2016 (similar to 2009-2010). It now appears to be slowing sharply (similar to 2011). The important point to note is that even with M1 at a growth rate of 14.5%, this represents 30% of GDP in new credit – more credit than Australia has created and has on issue.

China – M1 and M2 growth rates



Source: Macquarie

It's highly possible that this excessive credit growth continues, at least until the 19th National Communist Party Congress (which is due to be held in Sep/Oct 2017). President Xi Jinping is expected to win favour for another five years. The required structural reforms needed in China have not yet been implemented, despite the strength of the Chinese economy. Perhaps after Xi consolidates power, such reforms will become of greater focus.

Under normal circumstances, for an economy that is printing such an exorbitant amount of credit, one would expect downward pressure on their currency, reflecting more RMB worth less per unit of currency. However, given the RMB is not a floating currency, China's close to US$3 trillion of foreign reserves are being used to maintain a semblance of RMB stability, particularly given the pressures placed on it from capital outflows. The 'burn rate' on China's foreign reserves is approximately 2.5 years at the current rate. We suspect that once China's foreign reserves reduce to roughly $US1 trillion; renewed downward pressure will build on the RMB, at which point capital outflows will only exacerbate.

Should these events unfold, we would expect to see growth slow considerably as the RMB is likely to come under immense downward pressure. If the US dollar strengthens again on the back of more rate hikes by the Fed, we may see capital outflows pick up and the RMB come under renewed pressure (before the timeframe expressed above) as money flows to the higher rates of on offer in the US.

Further ahead, the outlook for China hinges on structural reforms, but these reforms are politically difficult for the Communist Party. If policymakers move quickly to tackle the debt build-up and resulting resource misallocation by forcing SOE reform and recapitalisation, then growth could feasibly stabilise at around 4-5%pa over the forthcoming decade. However, we suspect that a growing bad debt burden will intensify pressure on an already fragile Chinese financial system in coming years.

How all this plays out from an Australian equities perspective is critical. 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 for Australia. We would likely see an increase in the risk premium Australia requires, see the AUD fall, and our debt funding costs rise. We believe that our portfolios take good account of these Chinese risks.

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. While major supply side reforms are necessary, the Chinese Government has the levers to prevent a hard landing in the next few years. However, neither structural reforms in China (resulting in a need for less credit-driven FAI) nor a bursting of China's debt bubble, are good for the Australian economy (or Australian companies whose earnings are dependent on Australian economic growth).

Portfolio Positioning

The recent February reporting season slightly exceeded our expectations, albeit with a strong Resources-centric tilt. Resource companies showed a notable improvement in cash flow as cost-out efforts boosted margins, whilst the recent strength in commodity prices also assisted, with the full benefit yet to be seen in these results. Despite their strong results, resource stocks underperformed, implying broad profit taking and a view that commodity prices may have peaked for now. Financials showed relatively solid results, as Banks remained well supported by lower bad debts and improved NIMs. Insurers delivered improved results thanks to a better premium outlook. Industrials were mixed; with Staples recording improved results, whilst the Discretionary end recorded varied outcomes; those exposed to the housing market remain strong (JB Hi FI and Harvey Norman), whilst department stores and specialty retail showed signs of softness.

The recent reporting season has strengthened our view that the portfolio should 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 & Staples Retailing, Media, Commercial & Professional Services, Software & Services, Healthcare Equipment & Services, Pharmaceuticals, Biotechnology & Life Sciences and Energy.**

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

Conclusion:

We sense that the pressures are building in the Australian economy and expect companies exposed to the highly indebted Australian household sector (e.g. property developers, discretionary retailers, retail-focused REITs, commercial banks, etc.) will begin to confront a much more challenging and hostile earnings environment in the next few years. The portfolio is well positioned for this expected weakness in the domestic economy, having little or no exposure to the Australian Banks and Discretionary Retailers. The portfolio is also positioned for a continued improvement in the US economy, given the fundamentals of the US economy are strong, particularly the employment market, the stimulatory tax and fiscal environment and recovering business investment. 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.

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