JCP Investment Partners - Market Outlook 2015

January 2015

2014 was a more modest year for global equity markets with the MSCI World Index finishing up +7.7%. The Australian equity market finished the year up a meagre +1.1% (ASX 200). Our market underperformed the US (+11.4%), China (+10.8%), Japan (+7.1%) and Germany (+2.7%). The third quarter wiped out most of the year's gains, which were mainly attributable to weaker iron ore, coal and oil prices, which are now at five and a half year lows.

We expect 2015 to be a year of fairly 'normal' capital growth for equities, reflecting our view that the Australian market overall is currently fairly valued. However, without better earnings growth, it will most likely be an anaemic return year for equity markets.

One of the key challenges for markets in 2015 is excessively low inflation globally, but the BoJ, ECB and PBOC continue to fight it with accommodative policies, which we think will lead to inflationary pressures at some point in the future. Whilst equity valuations seem high, they are not in bubble territory yet, so we think this structural bull market can continue along its normal historic course for a number of years to come (see chart below "Australian Bull Markets"). However, we expect conditions to be less favourable over the next year or so as the US starts to normalise interest rates.

United States: Wage growth is the key to a continued recovery

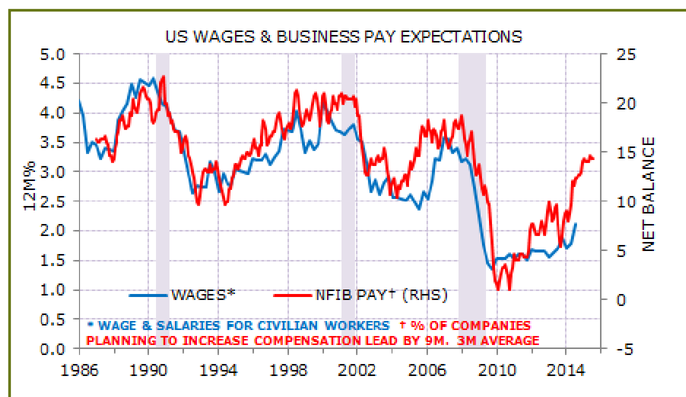
The US is important to the economic and equity market outlook in Australia because the trajectory on US interest rates largely determines the interest rate cycles for most other economies, especially small, open, foreign capital dependent economies, such as Australia.

We remain positive on the US economy and continue to favour US economic exposure in your portfolio. US employment remains strong; likewise consumer confidence is at its highest level since February 2008, and consumer spending (which accounts for more than two thirds of US economic growth) is growing at 3.2%. Strong employment has increased pressure on the Fed to raise rates; but our view is that 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).

Our key areas of focus within the US are: wages, the labour market, FOMC actions, the oil price, and inflation.

The US added 321k non-farm payrolls in November, so labour market conditions are improving rapidly. Even if the December employment payrolls are up only 200k, job gains last year would still total +2.9m, the largest annual increase since 1999 (+3.2m). We are expecting accelerating wages growth, a steady participation rate, and so on current trends unemployment will be well below 5% by year end.

For a country predominantly built on consumption, growth in nominal wages remains the key indicator going forward. Current conditions of cheap money, low unemployment, and a thriving innovation cycle continue to point to strong growth in wages (if not wage rates themselves just yet). The percentage of companies planning on increasing compensation is rising rapidly, evidenced by the following chart, and should this play out, labour stands to gain some pricing power as we move forward.



The inflation that matters (such as services inflation) still remains within a healthy range. We believe deflationary concerns are overstated. At the headline level (excluding the obvious impact of cheaper oil), core inflation is affected by deflationary forces, which do not present any immediate economic concerns. In fact, the Fed has suggested it will look through low inflation driven by one-off cheaper energy prices in its interest rate deliberations.

JCP follows the components of US CPI closely, looking for three key themes: (1) What level of inflation is seen in services; (2) Are there deflationary forces which are actually positive for the economy; and (3) How important are hedonic adjustments in other areas of consumer spending.

Services inflation is still reasonably strong. This is important because it has been shown that core services inflation depends on long-run inflation expectations and tightness or slack in the labour market, whilst core goods inflation depends on short-run inflation expectations and import prices. Over the coming year lower commodity prices and a stronger US dollar will only increase the deflationary forces on goods. This is a positive deflationary force because what matters is the amount of activity applied to those goods in the US, meaning there will be greater capacity for more jobs and higher wages. Finally, hedonic adjustments (increases in quality are reflected by deflating actual prices) of critical items, such as entertainment goods, drags inflation lower when people are still buying the newest and brightest items.

So in summary, services inflation remains relatively strong, and we would argue that spending on services has been a key reason why the current recovery has lagged that of previous business cycles.

Despite the strong signs in employment and consumer confidence, the recent ISM Manufacturing Index fell to a 6 month low (55.5 from 58.7), perhaps signalling a pause ahead for the US economic recovery. We expect the 5% annualised GDP growth experienced in 3Q14 will most likely revert back closer to 3%, which implies that activity is still rising at a healthy pace. Adding to the pause in the economic recovery is the rising US dollar, which may produce headwinds for exporters.

Despite the likelihood of a pause in the recovery, US equity prices should continue to move higher in 2015. Major declines are typically associated with tight money and/or major earnings declines, and neither is likely over the next 12 months.

It is possible that the market may have a correction at some point as the timing of the Fed's first interest rate increase approaches, but this should be seen as a merely a correction within a structural bull market.

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; at least, not until they get to a restrictive level (which is likely to be two or three years away). Equities will be in greater trouble if the Fed is not able to raise rates in the next couple of years, as that would suggest the economy has not recovered, having bearish implications for earnings.

From a portfolio perspective, we continue to favour companies leveraged to the US economy and a strengthening US dollar.

China: Slow successful rebalancing of their economy

From a JCP perspective, 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 see a further slowdown, but a successful rebalancing of their economy (countries with large domestic savings pools rarely have major sudden economic 'hard landings'). Recent rate cuts are designed more to manage the pace of the slowdown in fixed-asset investment (FAI), reduce financing costs, and provide relief on debt servicing, rather than a move away from the greater goal of structural change. As such, any upward influence on commodity prices is likely to be temporary.

Growth this year looks set to fall towards the low 7% level, trying to prevent it from slipping any further would hurt efforts to address credit risks and structural imbalances. Consumption growth has been broadly stable and should hold up well with the strength in wage growth. The key problem remains the downward pressure on growth from the overcapacity in many industries, which will weigh on investment.

We continue to believe that an economic hard landing can be avoided. However, it is clear that growth will be structurally slower moving forward, not least because Chinese exports face a more challenging global environment. Real estate excesses continue to unwind with construction and prices both falling.

In assessing China from an Australian economic perspective, in 2015 all eyes will remain on the 'old growth drivers' of housing and fixed asset investment. With regard to housing, the determination of a suitable baseline for housing commencements, and the role that large inventories will have, is critical. We doubt a turnaround is likely. For iron ore producers, the key will be how quickly high cost supply is mothballed, and the consistency of growth in the non-construction 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 they displace higher cost producers. They still have strong free cash flow growth, despite lower commodity prices, as a result of increased volumes and significantly lower capital and operating costs, and are fundamentally cheap given the negative sentiment surrounding the mining sector.

Europe: Stuck in its low growth environment for the foreseeable future

Despite growth in Europe remaining weak and inflation well below the ECB's 2.0% target, Europe appears to be slowly turning a corner (notwithstanding recently elevated risks around Greece). Economic data has been surprisingly on the upside, with surveys such as the IFO and ZEW forward indicators suggesting an improvement in conditions. Additionally, other things have improved, with the pace of decline in bank lending to the private sector easing, and the drop in both oil prices and bond yields expected to be positive for demand.

The ECB is expected to embark on a bond buying programme in 2015 to fend off deflation. We expect global equity markets to rally on an announcement by the ECB that it will purchase a large amount of government bonds. However, there still appears to be uncertainty about policy makers' willingness to adopt this action. Further QE by the ECB could also push the euro down further, helping export growth.

Russia recently had to increase interest rates dramatically by 6.5% to 17%, which is a salient reminder of a capital importer requiring higher rates to attract capital in order to roll debt, albeit at the expense of an already weakened Russian domestic economy due to a major fall in their terms of trade (mainly because of the fall in the oil price).

The bottom line is that the euro area seems likely to be stuck in its low growth environment for the foreseeable future. From a portfolio perspective we remain cautious on companies with eurozone exposure.

Australia: 2015 is a watershed year for the Australia economy

2015 will be a watershed year for the Australia economy as we transition out of a period of immense good fortune, i.e. our sixth terms of trade boom in 180 years.

History would suggest we have had trouble coping with transitions out of terms of trade booms. In our mind, the Australian economy has:

- been hollowed out by high costs and a high AUD;
- become too expensive in terms of labour and compliance;
- become over reliant on housing investment and "wealth effects";
- too few bullets left in monetary policy;
- too much debt in the household sector; and
- too high a level of structural spending in the Federal Budget.

So whilst Australia remains an attractive destination for foreign capital, a great place to visit and live, and a leader in many endeavours, these structural weaknesses will create formidable economic headwinds in 2015 and beyond.

On the global front, rates are likely to rise in the US at the exact point when Australia is in this unfavourable economic predicament.

As an importer of capital, Australia may well have to raise interest rates to attract foreign capital to roll over our debt, despite the negative impact this may have on the domestic economy (as discussed with Russia above), and probably during a period of economic weakness.

Looking at the key issues facing the Australian economy:

Nominal contraction in GDP: The 3Q GDP figures released in December were significant; only 9 times has our nominal economy (the one that drives company cash flows) contracted in the past 220 quarters. In addition, domestic demand per capita is also falling.

Low wage growth: Weak hour worked and high levels of migration all add to labour market stress. Real wages are falling, but even more competitive wages are required. At this stage the softest wage growth is being experienced in professional services and administration, whilst the industries which have slowed the most from the previous 5 year trend are mining, wholesale trade, and public administration. To regain international competitiveness in real wages we require the combination of lower AUD, rising productivity, higher inflation, and even lower nominal wages. Our concern is that with high levels of immigration and rising unemployment, nominal wages will do a significant amount of heavy lifting to regain competitiveness in the next 18 months.

Lower AUD: The 14% fall in the past year partially resets the economy, but it probably needs to fall further, and be sustainably lower for some period of time for productive new investment come through. Major impacts from a lower AUD for our portfolio include: higher realised income for low-cost miners; and higher COGS for a large part of retail sector.

Slowly rising unemployment: Appropriate concern by households about unemployment continues to be a factor in weak household consumption and consumer sentiment. The Westpac-Melbourne Institute Unemployment Expectations Index increased by 4.4% in Dec 2014. Apart from one higher print in March 2014, this is the highest reading since the GFC in June 2009. Major industry closures in key states in recent years, and higher population results in declining employment prospects.

Monetary policy: We expect that the market will price in interest rate cuts for 2015, simply because they are more likely than rises. But whether we actually have cuts depends on the RBA board balancing, on one hand, what they will actually achieve, and on the other hand, whether the firepower should be held in reserve (past severe economic downturns have needed about 5% rate cuts to stabilise the economy). The trade-off needs to be made between reducing rates because of low inflation, a soft economy, and AUD that is still too high; versus risking inflating further an already risky housing bubble.

Capex and investment intentions: In late February, data will provide the first estimate of capex intentions for the 2015-2016 year. This will be critical in assessing the mining capex cliff and the opportunities from other sectors to fill the gaps.

In the background there are other significant forces that will shape decision making, such as macro prudential policy; bank re-regulation; and a budget the nation can neither afford to sustain in the medium term, or slash in the short term, putting further downward pressure on the economy.

On the earnings front, consensus expectations for domestic earnings are +5.2% for FY15 and +8.9% in FY16. This compares to JCP's expectation of +1.4% over the same period. Cost out is likely to remain a feature of the upcoming reporting season, with revenue growth still very modest across most sectors.

From a portfolio perspective we have steered away from cyclical domestic exposures (e.g. discretionary retail, construction), preferring more defensive exposures, (e.g. gaming, staples).

Australia: Equity market outlook

Last year we forecast a relatively flat +2% price return for the Australian All Ordinaries Price Index, with +/-14.9% risk around this forecast (see table below).

Forecast Australian Equity Market Price Return & Risk

Year ended 31st December 2014	Probability	ASX All Ordinaries Price Index From		ASX All Ordinaries Price Index To	ASX All Ordinaries Price Index Return From		ASX All Ordinaries Price Index Return To
Units of measure:	%	Index	Index	Index	%	%	%
As at 31/12/14			5354.9				
Scenarios [to 30/04/2014]:							
Best case	10.0%	6519.1	-	8571.6	+21.7%	-	+60.1%
Optimistic case	15.0%	5999.8	-	6519.1	+12.0%	-	+21.7%
Base case	50.0%	4794.2	-	5999.8	-10.5%	-	+12.0%
Pessimistic case	15.0%	4794.2	-	4272.7	-10.5%	-	-20.2%
Worst case	10.0%	4272.7	-	3157.3	-20.2%	-	-41.0%
Total | Probability-weighted return	100.0%	4654.8	5453.1	6251.4	-13.1%	+1.8%	+16.7%
Probability-weighted risk						14.9%	
Return difference versus expeced return			5530.8			-1.5%	

The All Ordinaries Price Index returned +0.7% (towards the middle of our risk confidence interval of -13.3% to +16.7%).

Underlying this flat market over the last year was a wide divergence in returns between Industrials (+6.8%, including Banks +2.5%) and Resources (-19.0%), as a result of large falls in commodity prices, and a relatively firm Australian dollar given these commodity price falls.

Our 2015 forecast return for the Australian All Ordinaries Price Index is for a more 'normal' return of +4.4% reflecting our view that the market overall is currently fairly valued (-2.6% discount to our market-cap weighted bottom-up valuation universe).

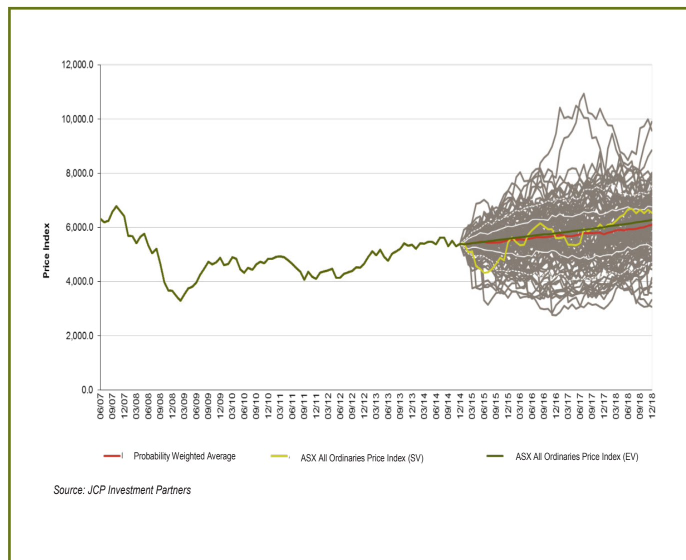
The risk around this expected return is +/-12.9%, and so we expect a 66.6% probability of a return between -8.5% to +17.3%.

Our scenarios for calculating these probability-weighted return and risk figures are shown in the table below.

Year ended 31st December 2015	Probability	ASX All Ordinaries Price Index From		ASX All Ordinaries Price Index To	ASX All Ordinaries Price Index Return From		ASX All Ordinaries Price Index Return To
Units of measure:	%	Index	Index	Index	%	%	%
As at 31/12/15			5570.9				
Scenarios:							
Best case	10.0%	7051.6	-	9161.1	+26.6%	-	+64.4%
Optimistic case	15.0%	6544.6	-	7051.6	+17.5%	-	+26.6%
Base case	50.0%	5187.7	-	6544.6	-6.9%	-	+17.5%
Pessimistic case	15.0%	5187.7	-	4742.8	-6.9%	-	-14.9%
Worst case	10.0%	4742.8	-	3743.5	-14.9%	-	-32.8%
Total | Probability-weighted return	100.0%	5096.1	5815.3	6534.6	-8.5%	+4.4%	+17.3%
Probability-weighted risk						12.9%	
Return difference versus expeced return			5692.1			+2.2%	

We also show on the following page our forecasts as a 'cone of uncertainty' for the next four years.

The best case scenario is the top 10th percentile of stochastic returns (above the white dotted line; the optimistic case the 75th to 90th percentile (between the solid and dotted white lines); the base case the 25th to the 75th percentile (between the two solid white lines); and so on.



Source: JCP Investment Partners

Despite our expectations for fairly ‘normal’ capital growth in calendar 2015, we would expect a reversal of sectoral performances to those seen in 2014.

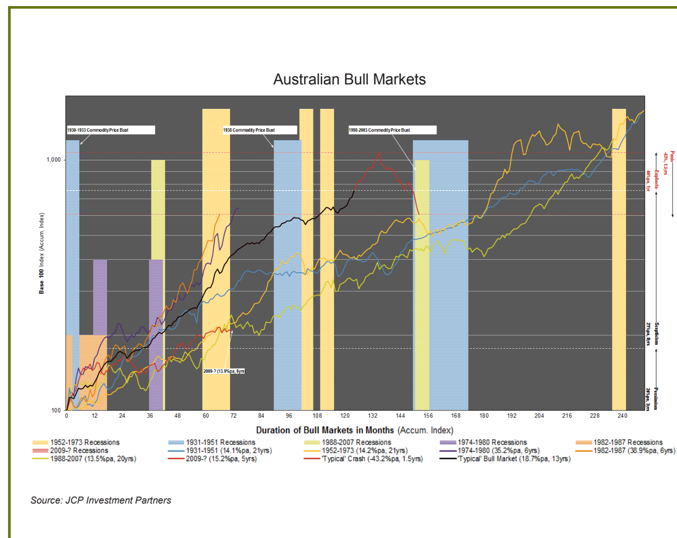
Commodity prices have fallen a long way in 2014, and are now marginally below our long-term equilibrium prices. Given the excess supply in most commodities, and the relatively weak demand outlook, we recognise that commodity prices could fall further in the next couple of quarters, but most of this downside risk is now factored into market expectations and stock prices. Furthermore, the contractual capital flows into the Australian dollar to fund large mining and energy projects are beginning to dissipate, which should cause further weakness in the Australian dollar and should benefit large exporters such as the resources stocks.

Domestic industrials, on the other hand, face rising costs (from the weaker Australian dollar), and weakening demand as the income shock from the fall in Australia’s terms of trade (>25% since June 2011) continues to negatively impact the highly indebted household sector’s disposable income (and also the Government’s fiscal position).

Further cuts to interest rates may offset some of these negative effects, but much of this ‘fire power’ has already been expended by the RBA with (arguably unnecessary) interest rate cuts from 4.5% to 2.5% (since August 2011), especially in an environment where US interest rates looks set to rise over the next three years.

Banks face a ‘trifecta’ of headwinds in 2015 and beyond. (1) Higher capital requirements (from an increased percentage of risk-weighted assets and through increased minimum risk-weights for mortgages); (2) increased bad debt charges as the income shock discussed above reverberates through the domestic economy; and (3) a rising interest rate cycle in the longer term.

Despite our view of ‘normal’ price returns over the next 12 months, given that we see the Australian market as fundamentally fair value from a bottom-up perspective, we are still longer-term very bullish. In bull markets confidence drives fundamentals higher via increasing business investment and innovation, which in turn drives employment, household incomes, consumer confidence and spending, and ultimately business profitability and equity markets. This demonstrates the reflexivity that exists between equity markets and the economy. This virtuous cycle is illustrated in the chart below which shows Australian bull markets for the last 100 years, and plots the progression of the post 2009 bull market (the red line originating at 100).



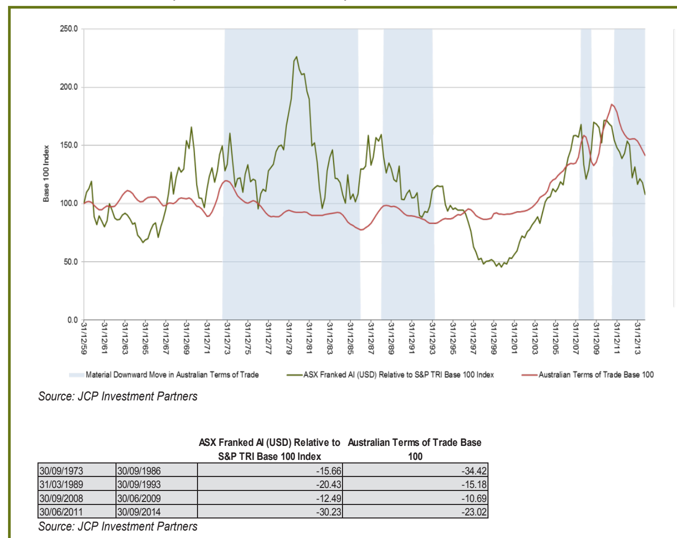
Source: JCP Investment Partners

The post 2009 bull market appears to be following a similar pattern to the 1988-2007, 1952-1973, and 1931-1951 bull markets. The compound average annual return for the post 2009 bull market has been 13.9%pa – versus 13.5%pa, 14.2%pa, and 14.1%pa, respectively for these earlier bull markets.

Australian Equity Market Outlook: The impact of lower terms of trade

The chart below shows the total return (including franking) of the Australian share market (in USD) relative to the US S&P500 total return index (the green line), in periods of rising and falling terms of trade in Australia.

When Australia’s terms of trade is moving materially downward, the Australian share market tends to materially under-perform the US market (see table below).



Source: JCP Investment Partners

		ASX Franked AI (USD) Relative to S&P TRI Base 100 Index	Australian Terms of Trade Base 100
30/09/1973	30/09/1986	-15.66	-34.42
31/03/1989	30/09/1993	-20.43	-15.18
30/09/2008	30/06/2009	-12.49	-10.69
30/06/2011	30/09/2014	-30.23	-23.02

Source: JCP Investment Partners

Therefore, in our view, the Australian share market performance, relative to the US market, will depend largely on what happens to Australia's terms of trade from here, which in turn is heavily dependent on commodity prices, and by implication, the growth rate in Chinese fixed asset investment. Our sense is that our market will continue to underperform major global markets again this year.

Conclusion

In 2015 we expect a year of fairly 'normal' capital growth for equities, reflecting our view that the market overall is currently fairly valued.

We remain positive on the US economy and continue to favour US economic exposure within the portfolio. We believe the Fed will raise rates later than the market expects and that the pace of subsequent hikes will be slow. Despite the likelihood of a pause in the recovery, U.S. equity prices should move modestly higher in 2015. Major declines are typically associated with tight money and/or major earnings declines, and neither is likely over the next 12 months.

For China, we see a gradual, successful rebalancing of their economy, but from an Australian economic perspective, all eyes will remain on the old growth drivers of housing and FAI. The euro area seems likely to be stuck in its low growth environment for the foreseeable future.

For the Australian economy, 2015 appears to be a 'watershed moment' as we transition out of period of immense good fortune to face the realities of our economic future – burdened with high costs (labour and compliance), overly reliant on housing investment and "wealth effects", and with too few 'bullets' left in monetary policy, too much debt in the household sector, and an excessive level of structural spending in the budget.

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 and 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.

Our conviction on the current positioning of the portfolio has never been stronger. 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 (e.g. low cost resources companies**); and unsustainable expectations and structural headwinds on the other hand** (e.g. commercial banks)**.**

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