JCP Investment Partners - September Quarter 2014

October 2014

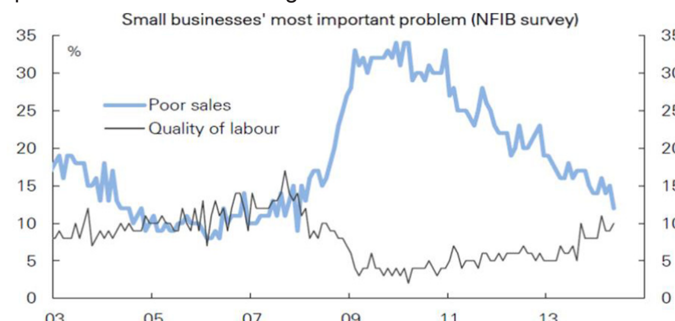
At the end of Q3 for CY2014, the Australian equity market (All Ordinaries Price Index) is down -1.05% for the year to date, within our January market outlook forecast range for a return for the Australian All Ordinaries Price Index of +1.8%, with risk around this return of 14.9% for the year. Our market fell -1.6% for the September quarter, underperforming the US S&P500 (+0.6%), Europe MSCI (+0.4%) and Japan (+6.7%), driven by weakening commodity prices and an overdue sell-off in the banking sector. The materials and financials (ex property) sectors were the two worst performing sectors for the quarter, whilst healthcare and telecommunications were the two best performing.

As written last quarter, we expected the second half of the year to be punctuated with both downside and upside volatility greater than what we have seen in the first half. The -5.8% fall in our market during the month of September was the biggest monthly loss since May 2012, driven by falling commodity prices, deteriorating growth indicators in Europe and China and an anticipated rise in US interest rates. Banks underperformed as concerns around additional capital requirements intensified. Our conviction in the positioning of the portfolio has strengthened, which will be expanded upon in the Portfolio Positioning section.

United States

The US economy is gaining momentum with GDP growth of 4.6% annualised in Q2 and at least 3.0% expected in Q3. The growth outlook is broadening with employment strengthening (the unemployment rate is now 5.9%, September 2014), housing remaining strong, with construction +14% for the three months ending August yoy and consumer spending improving, increasing by +0.5% in August mom and +4.1% yoy. US markets are reflecting this underlying improvement in the economy, recording their seventh consecutive quarterly gain.

These improved signs led to the Fed trimming its monthly asset-purchasing program again by $10 billion to bring it down to $25 billion per month, with an expectation that the programme will be halted completely in October this year. The Fed's plans for 2015 rate hikes might be serious, however we remain of the view that central banks will err on the side of staying too easy for too long, allowing inflation to increase. Arguably deflation fears have been holding back borrowing and spending, so higher inflation will most likely be viewed as a positive development. One specific area of improvement in the US being seen is in small businesses.



The chart above illustrates that small businesses are seeing better conditions; with the percentage describing "poor sales" as the most important problem they face shrinking almost back to pre-recession levels.

This is a positive development for a stronger US economy, which is starting to be seen in the bond market where some term risk is beginning to get repriced. A stronger US economy is positive for our portfolio, particularly when accompanied by a stronger US dollar.

From a portfolio perspective, we continue to favour companies leveraged to the US economy, particularly those that can benefit from higher bond yields and a strengthening US dollar.

China

Following our recent annual trip to China, we remain consistent in our view that China is experiencing a structural slowdown, albeit at a gradual pace.

A number of major themes emerged, such as: a tipping point in Fixed Asset Investment (FAI) is approaching, the anti-corruption campaign is here to stay, China's heavy industry economy is slowing and pollution problems are creating major changes in technology and innovation. Capital flows in to Australia are here to stay, the shift to consumption led growth is proving tough and China's new services economy is evolving fast.

China's new services economy actually looks really exciting and should ensure China continues a measured slow down, rather than a hard landing. The problem from an Australian economy perspective is that Australia stands to benefit little from the move away from China's old construction intensive economy to the new services led economy.

Our bearish outlook for the Australian economy is driven by this slowing of China's old economy and is reflected in our bulk commodity long run forecasts. We will continue our hunt for exposure to China's increasingly affluent consumers within their strengthening service economy, however as we learnt whilst in China, they have developed services business, such as those that operate in the education and tourism industries, that are already doing it better than many Australian companies are offering.

From a portfolio perspective, we are happy to maintain exposure to the lowest cost producers of iron ore that stand to benefit from increased volume as they displace higher cost producers. We expect that once the iron ore price settles at or around our long run forecast (US$67/t), the market will then focus on the free cash generation of BHP and RIO.

Europe

Growth in the Euro area still appears sluggish as the ECB attempts to overcome deflationary fears. The recovery appears to be losing pace with risks to the downside. Inflation has now slowed to the lowest level in five years whilst growth has also slowed.

Given the need for further stimulus, the ECB has cut interest rates to new lows and proposed to buy asset-backed securities and covered bonds, becoming more active in their attempts to restore growth. From a portfolio perspective we remain cautious on companies with eurozone exposure.

Australia

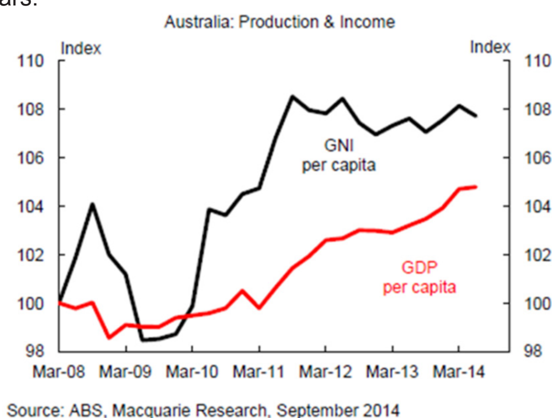
The deterioration in the Australian economy continues, with growth slowing to +3.1% yoy in Q2 versus +3.4% yoy in Q1 and domestic demand remaining subdued (+1.4% yoy).

Confidence continues to wane, with the index dropping to 94 in September from 98.5 in August. This hit to confidence has been compounded by Australia's falling terms of trade. Iron ore fell to a five year low in September (-17.4%) as waning demand in China

coincided with a surge in supply. Losses also spilled over to the coal sector, with the thermal coal price weakness continuing.

The RBA's forecast of the terms of trade is shown in the chart below. JCP forecast the terms of trade to fall to 70 by the middle of 2017, which assumes a 16% higher level than the average since 1960 (60.2). This compares to the RBA's forecast which assumes closer to 35% higher than the average since 1960.

The terms of trade are incredibly important to Australia given the transmission mechanism to national income. The chart below illustrates the recent national accounts, which shows the implication of our slowing economy and the declining terms of trade. It shows that real per capita incomes (GDI) have been flat for 3 years.



Source: ABS, Macquarie Research, September 2014

The remainder of 2014 and 2015 is likely to be no better. The flow through impact of lower national income will be significant for the industrial sector and eventually the banking sector, which we view as a leverage play on the Australian economy.

Given this outlook for the Australian economy, our market is likely to continue to underperform major global markets.

Portfolio Positioning

The portfolio is currently positioned for three key themes:

i). **Weakness in the domestic economy** – we expect a continuation of the decline in the terms of trade and lower national income. The portfolio is exposed to this theme via being underweight the banks and retailers.

ii). **An improvement in the US economy and a strengthening in the US Dollar** – we expect continued improvement in US employment, higher inflation and rising bond yields. The portfolio is exposed to this via overweights in QBE, FOX and BXB.

iii). **A structural slowdown in China, rather than a "hard landing"** – we expect China to manage their slowdown in a measured way, transitioning from the old heavy industry economy to the new services economy. We are bearish China from an Australian economy perspective given the decline in their heavy industries economy. The portfolio is exposed to this theme via exposure to the lowest cost producers of bulk commodities, which we expect to displace their higher cost competitors and provide capital management.

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

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

Conclusion

Our conviction in the positioning of the portfolio has strengthened recently given:

i). **Banks** – there are enormous risks around the Murray Financial System Inquiry, specifically increased capital requirements. We expect to begin closing out some of the bank underweights in to any potential capital raisings.

ii). **US Economy** – we expect rates to increase at some stage, which will further strengthen the US dollar. We are encouraged by the signs around employment growth and the first signs of inflation emerging.

iii). **China/Resources** – we forecast a long run iron ore price of US$67/t. At that level BHP & RIO are still very profitable as the lowest cost producers. Once the iron ore price settles at or around this long run price, this will become more evident to the market.

Fundamentally we think the Australian equity market is still moderately over-priced relative to our assessed fundamental value, however the ~6% fall in September has brought the market back closer to fair value (-3%). Whilst the recent pull back in our market has been long overdue, we remain structurally bullish on equities. This structural bull market still has a long way to go, being only a third of the way through a typical bull market cycle.

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