JCP Investment Partners – September Quarter Outlook 2016

October 2016

At the end of the September quarter, the Australian equity market (All Ordinaries Price Index) was up 3.4% for the calendar year-to-date. A volatile quarter saw the equity market rally over 6% in July before giving back part of those gains in August and September.

The Australian equity market was up 4.0% for the September quarter, outperforming the US (S&P500 +3.3%). However, Japan (Nikkei +5.6%) and the UK (FTSE +6.1%) performed stronger. We expect that markets will remain volatile throughout the remainder of 2016, particularly with the US Presidential Election ahead. Markets are currently not correctly pricing a Trump election win. If Trump is successful, 2017 stands to be a far riskier environment for equities given the heightened geopolitical risks ahead. In our January Market Outlook, we forecast a total return of +1.8% for 2016 (with a risk number of +/-11.8%). Our expectation is also that Australian equities will underperform global equities. This relatively modest growth expectation reflects our view that the Australian market is currently slightly cheap.

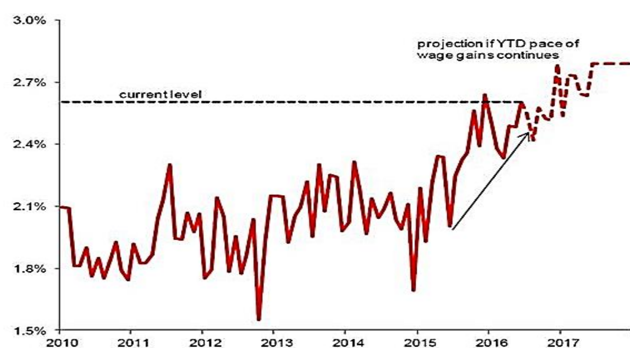
United States

US economy doing remarkably well but heightened geopolitical risk ahead

Having travelled to the US in September and met with various business, policy, and political contacts, we learnt that US domestic demand is strong, despite the barren and acrimonious political landscape that has dominated the US post the 2007 GFC. In a landscape where the decisions required of government and the investment sector for growth have stalled for a variety of reasons, the US economy is surprisingly doing remarkably well. The closer we got to people running real businesses, the more conviction we had in the strength of the US economy.

The wages story was as nuanced as the data suggests. Our preferred analysis, from the Atlanta Fed Wage Tracker, was corroborated. The US, as expected of a semi-regulated economy approaching full employment, is producing a variety of wage outcomes.

US: Change in Average Hourly Earnings – All private employees (y-o-y%)



Source: Macquarie Equities

Companies that are raising wages (those in growth industries), and those growing market share are paying up to attract new workers (switching wage growth is +3.7%) and to retain key staff. DR Horton (a US Builder) spoke of double-digit wage growth, but those workers on the edge of the labour market are faring much worse.

We have questioned whether Fed inaction is about the numbers or something else – a so-called third mandate. While we can only speculate, we consider that maintaining financial stability in a globalised world is also a key consideration for the Fed. Otherwise, the US economy has been performing too strongly for too long to sustain near zero rates. We think that the risks to yields are on the upside, given the strong economic fundamentals; but the geopolitical risk that would arise if Trump wins the election could keep the Fed on hold until December.

In regards to the US election, two key stories emerged: (1) the rejection of crony capitalism; and (2) the hijacking of political correctness to hide a system that the US public increasingly see as rigged. Clinton is viewed by many as both a symbol of crony-capitalism (expressed in a lack of trust by 74% amongst white men) and as part of the establishment system; unlike the "outsider" Trump.

The hijacking of political correctness is fascinating and relevant for Australia. Discussions in the US around immigration are important for two reasons: (1) it uncovers a potent level of support for Trump, and (2) it brings into the open a conversation that many are having. When Trump speaks on this issue, he is seen to have a willingness to have the discussions that no one else in Washington is apparently willing to have. In doing, so he highlights a "rigged system" that is seen by many to cover up “uncomfortable” issues. This disaffection concerns both the gridlock in Washington, as well as not talking about the things that everyday Americans are discussing.

If these themes hold in key swing states, Trump can win. The negative payoff is potentially large, and the market isn't fully pricing this – elites and insiders are simply “hoping” he won't win, and are largely relying on the “electoral math.” Downside risks will be priced in quickly if he does win.

So why are people downplaying the risks? There are two key reasons (both relevant to Australia). Firstly, Trump will be much more destabilising for the rest of the world than for the internal US. And secondly, the “checks and balances” placed upon a President provide a narrative, which ensures that even if Trump wins, he won't get anything done with either a hostile, or at the very least sceptical Congress.

Both reasons provide scope for concern for the rest of the world. In an environment where Trump finds it difficult to get things done internally, he may act more externally out of frustration. Doing so presents an increasingly risky and

volatile geopolitical environment for 2017. Furthermore, Executive Orders (which have been increasingly used by Obama) could impact health funding and trade policy, potentially placing Australia into conflict with its major trading partners, especially China.

One clear bright spot for the US economy is that innovation is alive and well, with numerous productivity-enhancing developments on the horizon. These innovative developments should drive higher profits in general, and may result in higher wages for those workers employed by companies and sectors that are set to benefit from this innovation.

One dominant feature of innovation is labour-replacement. We were impressed by the amount of upside still left in business transformation, supply chain management, and the deployment of robotics. Home Depot is exploring robotics for their distribution centres. UPS is investing $1bn over five years to automate their main hubs to reduce labour costs and are also looking to integrate autonomous vehicles into their network fleet while testing drones to deliver goods in remote places, such as Africa.

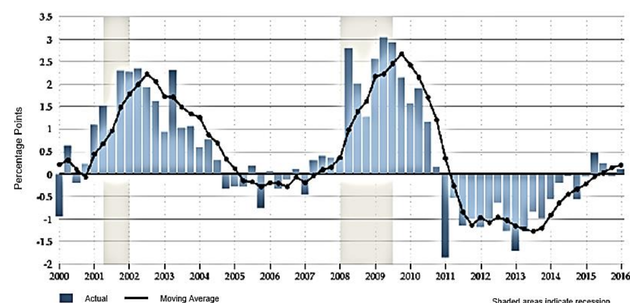
Another interesting area of innovation is aging at home technology, which will detect foot movement, given screens will be everywhere (being cheap and affordable) and bandwidth will be freely available.

JCP believes this context creates a fertile breaking ground for stronger future growth, especially when combined with more infrastructure investment. Both Clinton and Trump are proposing large infrastructure funding programs.

Although not huge relative to the size of the US economy ($250-$400bn over ten years), this would be a significant political success given the current budgetary constraints. Import replacing investment based on innovation will also be well received in an environment of increased nationalism, and brings with it the possibility of greater geopolitical tensions. Tax cuts and tax reform should also provide further economic upside.

We are also of the belief that fiscal policy needs to play a greater redistribution role given that the bottom half of the US population are suffering from increased inequality (with further threats of automation), while the top half are doing well. It is this cohort that is providing the impetus for the US economy via increased consumption, trading up, investing in housing, and driving credit growth. If the Fed is going to wait for the bottom half to drive inflation, it will be waiting a long time, and some of the bubble-like activity that the top half are driving will only continue.

The Contribution of Fiscal Policy to Real GDP Growth



Source: The Scowcroft Group, US

Fiscal policy is a way of achieving the necessary redistribution to accelerate the current US expansion. As the chart above illustrates, fiscal policy has been a drag on the economy for the past 4-5 years. If this turns around, it should provide the extra required impetus the economy needs. Trump has embraced deficit-expanding policies in his campaign speeches. Trump's proposals would raise the deficit by over $1 trillion per year, while Clinton's proposals would raise the annual deficit by only $25 billion. As a percent of GDP, Trump's stimulus would equal roughly 5%, compared to Clinton's at only 0.1%.

In summary, the fundamentals of the US economy appear relatively strong. The hollowing out of the middle class may well continue given the push towards automation and robotics by corporates, which will lead to increased profitability but not the better distribution of that wealth. This inequality, concentrated in the uneducated white male cohort, is a key factor that has given rise to Trump's electoral success to date. The probability of a Trump win is about 40%, and while his impact internally will be moderated by Congress, he could have an important impact externally given the role of Commander in Chief bestowed on the US President. The heightened geopolitical risk in the future (especially under a Trump presidency) is likely to result in increased market volatility which we think is not yet fully priced by the market.

In the environment described above, exposure to companies with US-derived revenue, such as Brambles and Ardent Leisure (through their US-based Main Event business), remains appealing given the greater external US risk if Trump wins.

China

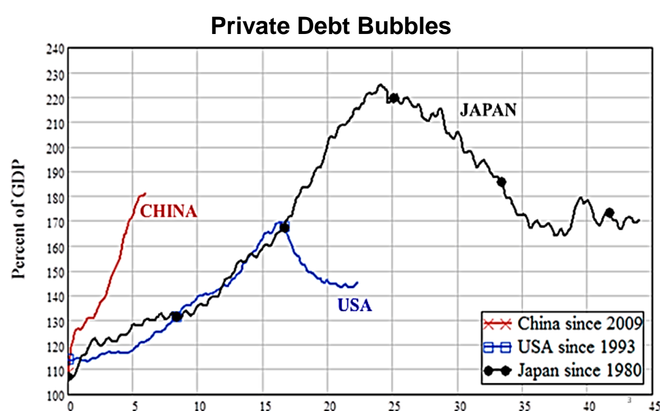
Unsustainable credit growth makes us cautious, plus heightened geopolitical risk ahead

We remain quite cautious towards China due to the major imbalances resulting from an excessive reliance on credit creation to generate investment-led economic growth.

China has relied excessively on credit creation from its banking (and shadow banking systems) to drive economic

growth and investment over the last 12 months. Since 2009 Chinese credit to the non-financial private sector has increased by around 90 percent of China's GDP. Such a rate of credit expansion has been much more rapid than that which preceded Japan's lost decade in the 1990s and that which preceded the US housing bust in 2007.

Private Debt Bubbles



Source: The American Enterprise Institute, BIS, IMF

The excessive amount of Chinese investment and credit creation has given rise to a tremendous misallocation of resources. Many sectors of Chinese industry, including the steel and construction sectors, now have significant excess capacity. Also, excessive credit creation has spawned bubbles in the Chinese property and equity markets.

The recent stimulus-led growth is working in the short term and is spilling over into the rest of the Chinese economy. Profits at large Industrial companies registered their highest growth since late 2013, rising 20% year-on-year in August, while Chinese consumers have also been doing well. The big question is how sustainable this is. A significant increase in house prices has also added to the sense of financial wellbeing recently, with Beijing, Shanghai and Shenzhen house prices all increasing by a third in the year to August. These increases have resulted from a combination of credit expansion, low mortgage rates, limited land supply, fears of an RMB devaluation, a loss of confidence in the domestic stock markets, and tighter restrictions on capital outflows.

The rhetoric provided by senior Chinese officials appears to fully recognise the imbalanced nature of the Chinese economy and of the need to promote economic reforms that might make China a more consumer and service driven economy. Their emphasis is on lowering debt levels gradually to avoid a sharp slowdown in economic growth. If such an adjustment is not forthcoming, the precedent from other credit-fuelled bubbles would suggest that China could experience a sharp correction in economic growth.

Another area of focus is Chinese capital outflows. While China still has more than US$3 trillion in international reserves, it is clear that China cannot sustain its recent pace of capital outflows indefinitely. Over the past few months, capital outflows from China have moderated with tighter capital controls, which had the impact of stabilising the RMB. However, there is a risk that China again looks to weaken its currency with the intent of stimulating export growth. In a low growth economic environment in the rest of the world, this could heighten tensions with China's trading partners putting further pressure on already weakening global trade.

We are also concerned about the increasing geopolitical risk building between China and the US. In a much weaker economic environment, social unrest would be a worrying issue for the Chinese Government who would likely respond with more nationalistic policies (e.g. expansionist plans in the South China Sea) that seek to build greater domestic social cohesion. As we learnt on our recent US trip, this would certainly result in a much more acrimonious relationship with the US.

Unfortunately, Australia could get stuck in the middle of these rising tensions by being forced to make difficult choices between its long-standing national security alliance with the United States and critically important economic relationship with China. We think Australia will err on the side of national security which in the future could have a negative impact on Australian trade causing damage to the Australian economy.

From a portfolio perspective, we remain cautious on exposure to China, given their unsustainable credit-fuelled, investment-led growth and emerging geopolitical risks.

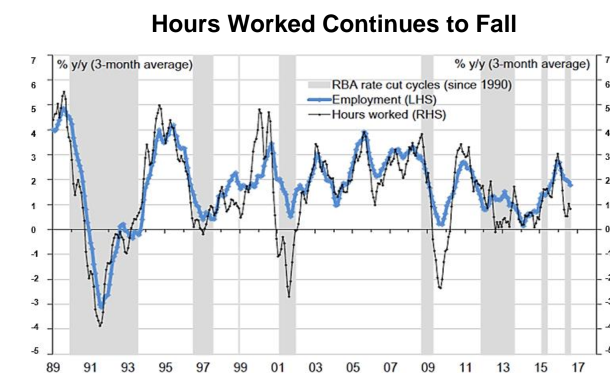
Australia

A challenged outlook

Our views on the Australian economy have not changed a great deal since our June Quarter Outlook. The Australian economy continues to accumulate unsustainably high levels of household debt in an environment of low household income growth.

The employment market may appear fine at the headline level, but the shift to flexible part-time work has meant that the number of hours worked continues to fall (see chart below), resulting in continued weak income growth.

Hours Worked Continues to Fall



Source: UBS

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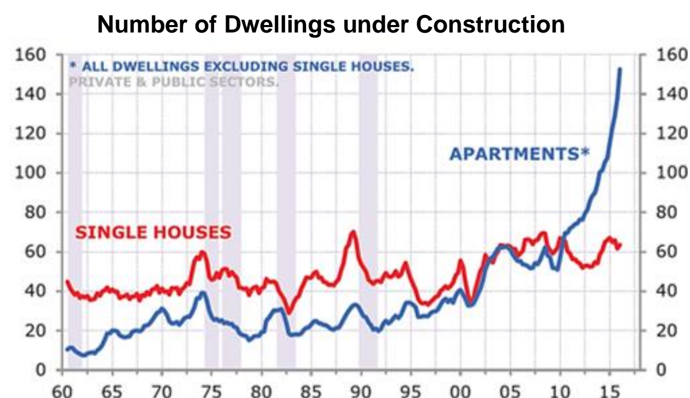
The recent August reporting season was mixed, with more downgrades than upgrades. Profits also look likely to contract for the second consecutive year. There were mixed messages from the Australian consumer sector. The wealth effect from higher property prices supported discretionary retailers, whilst other parts of the Australian economy underwritten by debt expansion and immigration (such as housing-related retailers like Nick Scali and JB Hi-Fi) were stronger. Other economically sensitive sectors such as REITs, telcos, domestic media and supermarkets did not perform as well. It was clear that banks continue to face a tough environment, with a challenging revenue growth outlook and higher funding costs.

While it is too early for apartment settlement risk to impact higher bad debts, there are clear signs that we are entering a credit cycle, with bad debts rising off unprecedented lows. Another headwind is higher capital requirements, tougher regulations, and greater political scrutiny forcing banks to appease disgruntled customers.

Our ongoing concerns about the Australian economy include the: (1) elevated level of household indebtedness; and (2) lack of household income growth to support these increasing debt levels. As recent warnings from the IMF highlight, this could result in an unfavourable credit cycle in the future, causing a significant derating of Australian banks from (in some cases) above 2x book value to well below 1x book value.

The apartment market is particularly interesting, with the number of dwellings under construction rising rapidly over the last couple of years and the number of approvals even higher! We are concerned that this rapid increase in supply will eventually lead to falling prices, increased settlement risk, and higher loan defaults, especially in an environment where there is little scope for further interest rate cuts by the RBA.

Number of Dwellings under Construction



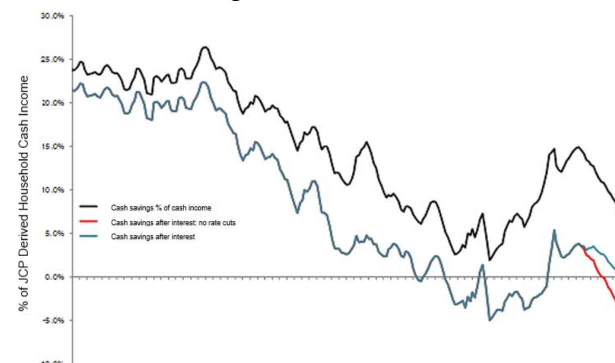
Source: Minack

The recent Q2 2016 GDP figure of 0.5% resulted from growth in government spending and changes in inventories, but domestic demand remained very weak with private demand only increasing by +0.5% year-on-year. Over the last few years, the Australian economy has been held together by building construction activity, which is now starting to show signs of weakening.

Recently the terms of trade have provided a boost to Australia's nominal GDP. China stimulus measures have driven iron ore and coal prices significantly higher over the last six months. However, we don't think these prices are sustainable given the recent credit bubble in China driven by their stimulus measures. Therefore, we expect a slowing Chinese economy will put downward pressure on commodity prices as we move into 2017.

The household expenditure component of GDP was weaker than expected (+2.9% year-on-year, the weakest in three years), mainly driven by lower income growth. However, despite the weaker household expenditure, the cash savings measures of GDP continue to fall precipitously. Only recent interest rate cuts are holding the household sector of the economy together.

Household Cash Savings % of Income Before and After Interest



Source: ABS National Accounts, JCP Investment Partners

In summary, we remain concerned about a deeper slowdown in domestic demand growth, driven not only by falling mining capital expenditure but also by a weakening household sector.

From a portfolio perspective we continue 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

This recent reporting season has strengthened our view that our portfolios 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. Exposure to the "silver dollar" - the ageing baby boomer demographic in Australia: hospitals, superannuation, aged care and death.

The major **overweight sectors** for the portfolio are: **Insurance, Consumer Services, Food & Drug Retailing, Media** and **Software & Services**.

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

Conclusion:

The portfolio continues to be well positioned for the growth trajectory in the US economy and the economic headwinds we see facing the Australian economy over the next few years. 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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