

January 2012

2011 proved to be a roller coaster year marked by extraordinary volatility, which reflected a widespread lack of conviction. The ASX 300 finished the year -14.9% and + 1.15% for the December quarter. The imbalances that have been weighing on markets are still in place. Balance sheets are still burdened with too much debt, while policy interventions and ongoing political uncertainty are not allowing markets to clear. Continued monetary accommodation, fiscal restraint and deleveraging point to another volatile year ahead. The market may end 2012 higher, but it will be another volatile ride, especially if a Euro-area break up scenario occurs.

## Europe: The Big Risk Factor

Europe's last great schism occurred with the Protestant Reformation in the 16th century. Prior to this the Roman Catholic Church was the uniting force within Europe. Will 2012 be the year of the next great schism of attempted European co-operation? The answer to this question will be a key determinant of what happens to financial markets in 2012. Our view is that a break-up of the Euro currency block is inevitable. Whether this occurs in 2012 [2013 or some later date] is really a question of the strength of the incumbent political will to keep the Euro in place. However, economic rationalism will ultimately determine the fate of the Euro given the fundamental differences in the competitiveness of the constituent economies. This has resulted in large accumulated capital account imbalances and a massive build-up of debt within deficit countries, intermediated by the European banking system thereby creating a banking crisis, which has been underwritten by European Governments thereby creating a sovereign debt crisis within Europe.

In "This Time Is Different", Reinhart and Rogoff prototype the sequencing of economic crises, whereby banking crises are followed by a currency crash, inflation and default. They also make the point that "...currency crashes tend to be more serious affairs when governments have been explicitly or even implicitly fixed (or nearly fixing) the exchange rate." This prognosis does not bode well for the future of the deficit countries [Portugal, Ireland, Italy, Greece, and Spain; i.e. the PIIGS] in the Euro and the consequences of their exit – inflation and default. Europe's problems will also be compounded by a likely recession in 2012, resulting from harsh austerity within the PIIGS economies.

However, a delay in the break-up of the Euro beyond 2012 may occur given a greater involvement of the European Central Bank [ECB] to underwrite the European banking system through its Securities Market Program providing unlimited 3 year loans to commercial banks in Europe. The strong use of this facility to date should directly help facilitate the large financial and sovereign debt re-financings scheduled for 2012. There is also some scope for progress towards some sort of Eurobond mechanism backed by greater fiscal union. However, the full fiscal union required to sustain the Euro long term seems unlikely given the need for individual countries to forego their fiscal sovereignty which would be politically difficult to achieve.

## United States: A Glimmer of Hope

The US economy has shown definite signs of improvement in the last quarter of 2011 aided by extended monetary and fiscal stimulus from the Federal Reserve [Fed] and US Government. Consumer spending has positively surprised, but income growth has still been disappointing reflecting the still poor state of employment growth and the high unemployment rate. The US housing market has shown signs of bottoming out, but a real recovery is only expected to occur when employment growth significantly improves.

Although employment has shown some recent signs of improvement [e.g. lower initial jobless claims], progress is expected to be slow given the need for fiscal contraction to bring the US Government deficit down, and the ongoing deleveraging process that needs to occur in the household sector. Despite the apparent strength of the business sector, there still seems to be a reluctance to increase investment and employment given the economic uncertainties in the global economy, and political and fiscal uncertainties domestically.

In the long term there are still risks of greater debt monetisation by the Fed resulting from a political unwillingness to deal with growing fiscal pressures. However, the inflation consequences of such actions are beyond the outlook for 2012, especially if the US economy continues its modest growth trajectory, thereby reducing the need for additional quantitative easing. On the contrary, the Fed's strategy at this point seems to be to provide greater economic transparency of its future interest rate decisions, rather than embarking on a new round of quantitative easing.

## China: The Great Hope

The Chinese economy slowed down measurably in 2011, but this was largely engineered to bring inflation down to more manageable levels. Economic growth indicators, such as money and credit growth, suggest that the economy may continue to slow in the first quarter of 2012, but the Chinese Government seems acutely aware of the risks if economic growth falls too much and has ample monetary and fiscal policy latitude to respond accordingly.

The main risk factor for China is a disorderly collapse of the Euro and its consequential impact on Chinese exports to Europe – its biggest export destination. If this were to occur in 2012, then we would expect the Chinese Government to respond as they did in 2008/09 with a sizable increase in investment spending [probably through the banking system again], but with much less ferocity given the inflationary consequences resulting from the 2008/09 stimulus.

It will also probably look to rely more on boosting domestic consumption and less on private residential property development for any growth stimulus.

The other risk factor for China is disorderly deflation of the Chinese property bubble. To date this seems to have been managed reasonably well by the Chinese authorities, probably because of the relatively low amount of bank debt used to inflate this bubble. However, with property prices now falling, this will undoubtedly reduce investment in this sector and continue the 'media noisy' unrest in the wealthier middle class of Chinese society. This sector is commodity intensive [steel, cement, etc.] and so any reduction in private residential investment will decrease demand for hard commodities, which in an environment of increasing supply, may continue to put pressure on these commodity prices. Despite these risks, China has the fiscal and monetary ammunition to offset any decline in external demand, as such we feel that a hard landing in China is unlikely, and see good value in resources.

### Australia: The Lucky Country

Since the global financial crisis [GFC], the Australian economy has been in the fortunate position of being an exporter into Asian economic growth, and more specifically [post the GFC] Chinese economic stimulus which has been largely focussed on commodity intensive infrastructure and property investment. This has meant much higher hard commodity prices, and consequently much higher terms of trade and national income for Australia. The corollary of high commodity prices has been a massive investment boom in commodity projects that should keep Australian economic growth reasonably strong over the next few years. However, this strong resources investment boom has meant higher interest rates and necessarily weaker household spending [especially on more discretionary retail items] and investment [e.g. housing investment] to keep inflation in check, thereby creating a 'two-speed' economy which we expect to continue in 2012, abetted by continued household sector deleveraging from still relatively high levels.

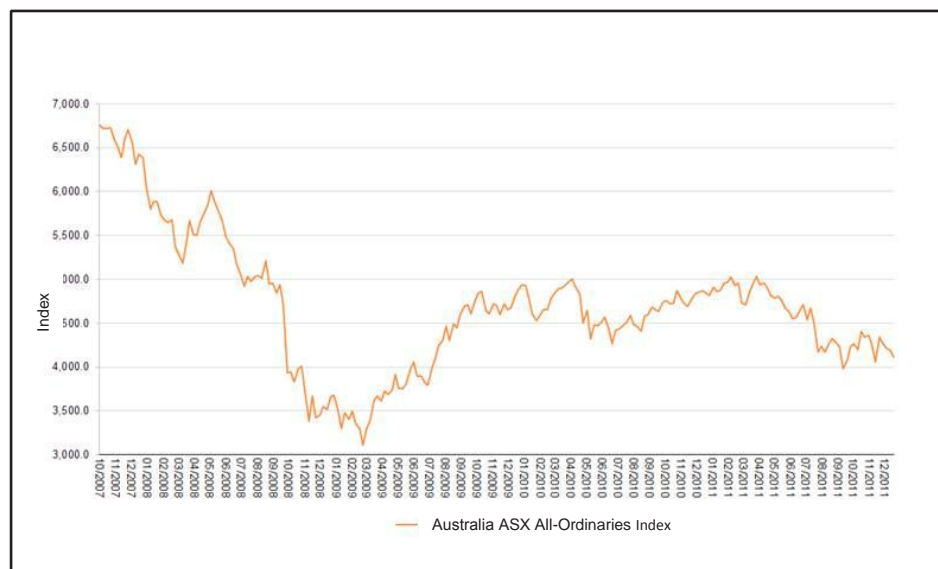
Despite the strong resources investment boom, we see the risks to the Australian economy to be on the downside. This is evident in recent employment and consumer reports [e.g. retail sales, consumer confidence, etc.]. These risks will be compounded if the Euro collapses in 2012, resulting in a credit crunch [credit availability to Australian commercial banks] and an export shock to China. There are policy levers that will no doubt provide some relief in such circumstances such as lower interest rates and a falling Australian dollar, but this time around, there will be less scope for the fiscal stimulus seen in the GFC. As has been the case for the last few years, 'it all hangs' on China, but we are less negative on the short-term economic outlook for China than many market commentators, although we do share the longer-term concerns around productivity outcomes, and the investment imbalance that exists in the Chinese economy.

### Australia: Equity Market Outlook

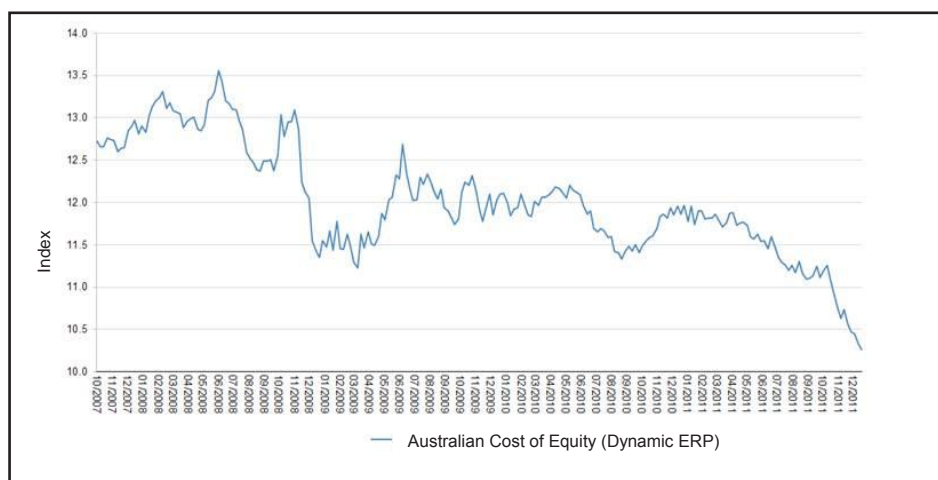
Last year we predicted a flat Australian equity market for 2011, i.e. 0.9% price return, with 18.6% risk around this forecast. Our scenarios for calculating these probability-weighted return and risk figures were:

Forecast Australian Equity Market Return & Risk Scenarios (Year ending 31 December 2011)	Probability %	Index Price Return %	Risk %
Optimistic case	15.0%	22.0%	0.7%
Base case	50.0%	12.0%	0.7%
Pessimistic case	35.0%	-24.0%	2.0%
<b>Total (Probability weighted)</b>	<b>100.0%</b>	<b>0.9%</b>	<b>18.6%</b>
<b>Confidence Interval</b>	<b>-17.7%</b>	<b>0.9%</b>	<b>19.5%</b>

The All Ordinaries Price Index fell 15.1%, which was within our risk confidence interval of -17.7% to +19.5%, albeit towards the bottom end of the range.



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Our expected price return for the Australian equity market in 2012 is for 4.0% return, with 15.3% risk around this forecast. Our scenarios for calculating these probability-weighted return and risk figures are:

Forecast Australian Equity Market Return & Risk Scenarios (Year ending 31 December 2012)	Probability %	Index Price Return %	Risk %
Best case	5.0%	42.7%	0.9%
Optimistic case	10.0%	16.8%	0.3%
Base case	40.0%	10.9%	0.5%
Pessimistic case	30.0%	-3.8%	0.0%
Worst case	15.0%	-20.5%	0.6%
<b>Total (Probability weighted)</b>	<b>100.0%</b>	<b>4.0%</b>	<b>15.3%</b>
<b>Confidence Interval</b>	<b>-11.3%</b>	<b>4.0%</b>	<b>19.3%</b>

Our risk interval for 2012 is a return from -11.3% to 19.3%.

The **best** case scenario builds on the assumptions of the optimistic case, including also: (1) an increase in earnings growth to 4.5%pa [6.5% for the next year, 5.7%pa for the following 7 years, then 4.2%pa thereafter]; and (2) a realisation of the resultant market discount [-26.8%] over the next year. This scenario is reflective of Europe moving down the path of full fiscal integration, starting next year with the member states beginning to issue Eurobonds in return for moving in this direction. The Euro falls thereby stimulating economic growth in Europe, economic growth continues to strengthen in the US, Chinese growth stabilises with lower inflation, and commodity prices resume their upward momentum [albeit at a lower trajectory than that seen coming out of the GFC].

The **optimistic** case scenario again reflects the assumptions of the base case except for: (1) a decrease in the equity risk premium to its long-term historical average [down to 6.3% from the current 6.6%]; and (2) a realisation of the resultant market discount [-20.6%] equally over the next 2 years. This scenario is economically similar to the base case, but with a slightly better outcome in Europe [i.e. a move to greater fiscal transfers from Germany via some sort of Eurobond or the ECB, and better fiscal outcomes in Southern Europe resulting from the austerity measures being undertaken there].

The **base** case scenario reflects current: (1) interest rates [10 year Australian Government bond yield = 3.8%]; (2) equity risk premium [ERP = 6.6%]; (3) earnings growth of 4.1%pa [4.5%pa for next 3 years, 3.7%pa for following 5 years, then 4.2%pa thereafter] in line with our research analysts' bottom-up forecasts; and (4) a realisation of the current market discount [-17.4%] equally over the next 3 years. This scenario implicitly assumes that the Euro holds together in 2012, Chinese growth begins to accelerate into the latter part of 2012, and the Australian economy [although still 'two speed'] continues to grow at a moderate pace [with or without further interest rate cuts depending on the economic circumstances].

The **pessimistic** case scenario reflects the assumptions in the base case except for: (1) an increase in risk premiums [both real interest rates and ERP] which pushes up the cost of equity by about 3.5% [i.e. similar to that seen during the GFC]; and (2) a realisation of the resultant market premium [+15.9%] equally over the next 2 years. This scenario is similar to the GFC but caused this time by the break-up of the Euro, resulting in a similar rise in risk premiums and policy responses from the US [via quantitative easing] and China via fiscal and monetary policy stimulus [see our section above on China].

The **worst** case scenario builds on the assumptions in the pessimistic case, including also: (1) a large fall in earnings growth to -1.3% [-10.5% for the next year, -3.8%pa for the following 7 years, then 4.2%pa thereafter]; and (2) a realisation of the resultant market premium [+24.1%] over the next year. This scenario reflects a disorderly unravelling of the Euro, a failure of quantitative easing to stop the US sliding into another recession, and a substantial drop in Chinese growth to 2-4%pa despite a stimulatory policy response. This causes a substantial drop in commodity prices, Australia's terms of trade, and its nominal economic growth rate.

# JCP Investment Partners – Market Outlook 2012

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## Conclusion

As was the case last year, 2012 will be extremely difficult to call from an Australian equity market perspective. There are still significant risks associated with what happens to the Euro and its impact on global confidence and economic growth. Australia is still reasonably well placed to 'weather any tempest' that may come from a break-up of the Euro, but this will be dependent on the policy response to such an occurrence from China and the US, and the impact of this policy response on hard commodity prices, and our terms of trade, etc.

The JCP investment universe implies that valuations are reasonably cheap rather than extremely cheap. The markets are priced for an environment of weak growth, but are not pricing in a global recession or Euro-area breakup/credit freeze scenario. We continue to like gold as a hedge against further economic and financial turmoil. The environment of easy money and financial instability should stay supportive of gold. We see reasonably good value in large cap resource companies and have been happy to reweight the portfolio towards resources given our "soft landing" view on China. The JCP portfolios continue to be overweight resources and insurance, whilst underweight banks, retail and property trusts.

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