JCP Investment Partners - Market Outlook 2013

January 2013

2012 was a relatively strong year for the Australian equity market, especially the second half of the year, after concerns regarding the Euro zone break-up eased and China's short-term economic outlook stabilised. The ASX 300 finished the year +14.2%, and +5.8% for the December quarter which was aided by further global central bank stimulus. While there are many major economic and financial issues that still need to be fully resolved (e.g. European economic weakness, US debt ceiling and longer-term fiscal challenges, international trade imbalances, banking sector stability measures and regulation, financial deleveraging in many countries, etc.), we expect 2013 to be a year of continued market optimism, with further progress being made on these issues, aided by extensive monetary stimulus and the resultant wealth transfers, thereby bringing greater confidence to equity markets.

Europe: Progress being made

The European Central Bank (ECB) has made some good progress in 2012 to reduce the risk of further sovereign bond crises and banking system seizures by implementing additional, and potentially more potent 'lender of last resort' measures. This includes providing ample liquidity to the European sovereign debt markets in exchange for the more challenged European economies (e.g. Spain, Italy, Greece, Ireland, etc.) implementing further fiscal adjustments.

The ECB effectively ended the threat of a systemic banking failure by announcing unlimited financing to the region's banks. Additionally, the ECB's Outright Monetary Transactions (OMT) program is playing an important role in capping sovereign bond yields and preventing market panics. Major fiscal adjustments are also taking place, with some periphery countries expected to reach a primary fiscal surplus in 2013. Additional progress is also being made by some of the peripheral countries towards closing the unit labour cost gap with Germany, boosting their competitiveness. Despite this progress, economic growth in the region is still very weak, however the region should exit its current recession in 2013, which will be positive for markets.

There remains a strong political will to keep the single currency in place, but success will depend on boosting economic growth and reducing unemployment. We still think there is a 60% chance that the EMS breaks up at some stage given the structural imbalances that we think will be very difficult to deal with over the longer term. But over the next 12 months we expect ECB initiatives to calm immediate fears and help boost market confidence levels.

This is important for the Australian equity market because it impacts: (1) Chinese manufacturing; (2) Australian bank wholesale funding; and (3) equity market confidence globally.

China: Cyclical upturn underway

The impact of the Euro crisis on China has been material because of the importance of its exports to Europe (a fifth of Chinese exports). With demand from Europe shrinking, manufacturing in China has been plagued with excess capacity.

The build-up in inventories led to a cut in prices and production, particularly in the steel sector.

Our proprietary contacts in China inform us that there is an expectation that the Chinese economy will improve this year with the new Government expected to implement significant reform initiatives.

Importantly (from an Australian equities perspective) we are starting to see supply in the met coal market tighten post the Government closing some 20% of small mines due to accidents and environmental concerns. Market sentiment within the steel sector has improved from three months ago, with production increasing by about 4%. This improved sentiment has seen the iron ore price rebound strongly since August, up from $89/t to about $150/t at present.

Despite the new Government stating that they will enhance the property tightening measures in coming years, China property sales have been surprisingly strong in December. Also new starts of public housing have been stronger than expected. Developers appear to be starting to re-stock land, having been previously focused on de-stocking in 2011 and 2012. We have recently seen the first consecutive months of positive land acquisition data since 2011.

Despite these data points, our proprietary contacts suggest that there is no real sign of end user demand improving for steel as yet, with steel producers continuing production simply to cover their fixed costs and hoping that more construction in Tier 3 and 4 cities will help steel demand in the future.

The increase in steel production (and demand for met coal and iron ore) is concerning given there are not yet any real signs of end user demand from the construction market. While the improved sentiment, which has led to the rally in the iron ore price, should benefit our portfolios given our relatively large weightings in Rio Tinto, we see this improved sentiment more as an opportunity to reduce our resource sector weighting.

The Chinese economy will likely experience a cyclical upturn in 2013, with measures such as the purchasing manager's index moving higher. The new Central Government is expected to be tougher than the previous regime, focusing on anti-corruption measures and implementing reforms which should put the economy on a much better longer-term footing (i.e. more consumption lead growth, and less dependence on investment and net exports).

From a stock perspective we continue to see some value in Rio Tinto, which rallied 23% in the December quarter. However, based on this rally, we reduced our position given our concerns about the sustainability of the recent iron ore price increase. We expect prices to settle back around $110/t over the coming year. Our long term iron ore forecast is $78/t (in current dollars).

United States: Bullish outlook

Much of our improved equity market optimism for 2013 relates to our more bullish view on the US economy and the impacts of a rapidly expanding US money supply. Increased US Federal Reserve (Fed) liquidity is not only having a positive effect on market sentiment and asset prices, but there are also early signs of improvements in the real economy.

We expect the Fed to continue to expand their balance sheet, with recent announcements suggesting that monthly net asset purchases will increase from $40bn to $85bn. Over the next several years we expect these initiatives to increase the US money base from its current level of $2.6t to around $4.0t. Assuming that the US money multiplier returns to its long-term average of around 8x from its current historic low level of about 4x, then this would lead to an increase in the broad money supply (M2) from its current level of $10t to over $30t!

The major longer term problem in the US is its structural fiscal deficit and the uncertainty around how to deal with it. Ultimately, US Government debt needs to be put on a more sustainable path (i.e. it needs to decrease from its current level of over 100% of GDP to around 60% of GDP). Growing nominal incomes to inflate away much of this debt is the key focus of the Fed and its Government masters. The Fed would have the markets believe that it will look to reduce the size of its balance sheet when higher inflation emerges, but historical precedents are not consistent with such central bank balance sheet reductions.

There has been a significant amount of pent up demand in discretionary and business investment due to concerns over the ‘fiscal cliff’, the sovereign debt and banking problems in Europe, and the weakening Chinese economy. As these risks have diminished, and given the fact that US corporate balance sheets are extremely healthy and energy prices are falling, it is likely that we should soon see an uplift in business investment. Early indicators on investment such as residential construction and motor vehicle sales have been positive. Broadly speaking, stronger business investment should lead to a better second half for the US economy.

In the long-term, real economic growth is all about productivity gains, and with the significant shift in the cost of energy, thanks to the shale gas and liquids revolution in the US, productivity is likely to get a real boost. This, coupled with a weaker US currency due to Fed monetary policy, is likely to see manufacturing move back to the US from Asia over time, providing an added boost to the US economy.

In the near term, there will be some fiscal drag (the payroll tax increase will lower disposable income by about $110 billion or 0.7% of GDP), coupled with another looming budget battle as the political parties have to deal with the debt ceiling and the budget over the next couple of months. This makes us a little more cautious in the short-term.

Sectors within the Australian equity market that should benefit from rapidly expanding US money supply and stronger nominal US economic growth include those that are more highly leveraged, and those exposed to real assets, such as commodities (and their suppliers and customers), as opposed to paper assets or competitive services, such as financial services (and their suppliers and customers).

Australia: Mixed economic fortunes

The Australian domestic economy’s fortunes are closely linked with those of China. Therefore, the cyclical upturn we expect in China should be positive for the Australian economy in the year ahead.

However, there remain some large challenges for the Australian economy, with credit growth being at three year lows, house prices remaining stagnant, the banks holding an elevated level of impaired assets, employment lead indicators looking poor, and the Australian dollar strength impacting manufacturers and exporters. This will all put more pressure on Australian household incomes, increasing the impetus to increase savings and delever their balance sheets, thereby increasing top line pressure on many Australian businesses.

The good news is that the RBA still has significant scope to ease monetary policy further, which we think will be necessary in 2013; and also the Federal Government seems less besotted with budget surpluses at any costs, and more willing to run fiscal deficits to support employment and economic growth.

Australia: Equity Market Outlook

Last year we forecast a moderate +4% price return for the Australian All Ordinaries Price Index, with 15.3% risk around this forecast. Our scenarios for calculating these probability-weighted return and risk figures are shown in the table below.

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%
Total (Probability weighted)	**100.0%**	**4.0%**	**15.3%**
Confidence Interval	**-11.3%**	**4.0%**	**19.3%**

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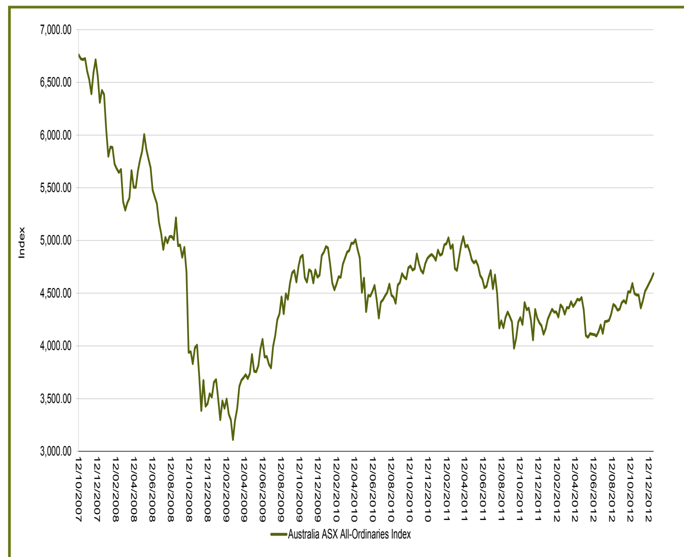
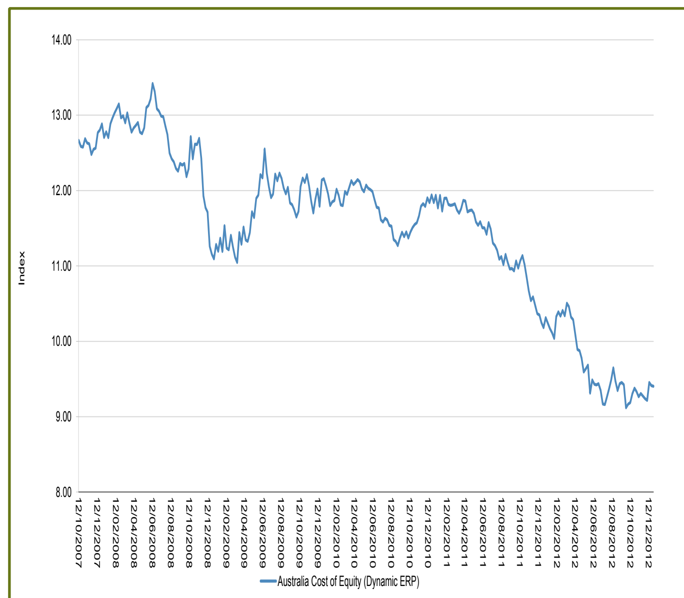
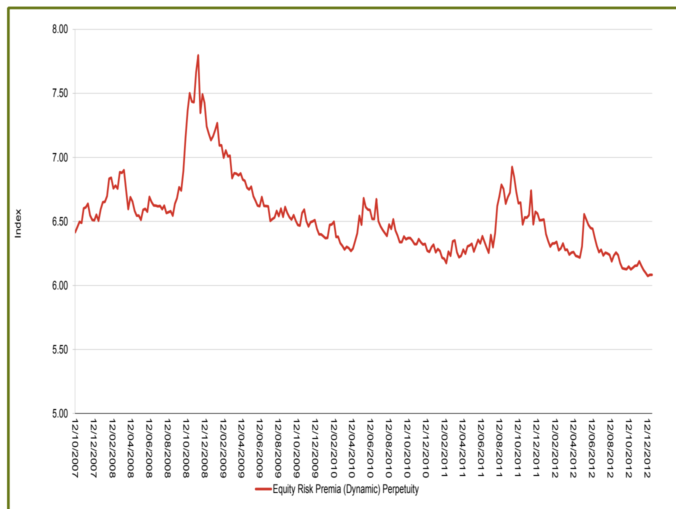
The All Ordinaries Price Index returned +13.5% (within our risk confidence interval of -11.3% to +19.3%, albeit towards the top end of the range). See chart below.

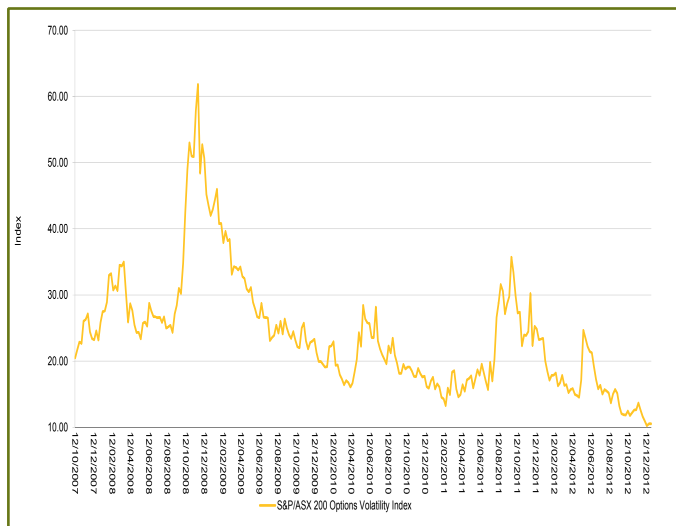


This positive return was driven by a reduction in the cost of equity for the Australian market from 10.3% at the start of 2012 to 9.4% at the end of the year, and occurred despite profit downgrades over the year. See chart below.



This reduction in the cost of equity was driven not only by a fall in the risk-free rate (Australian 10-year Government Bond Yield) from 4.1% to 3.3%, but also a reduction in the equity risk premium from 6.3% to 6.1%, which in turn was reflected in the fall in the VIX from 23.3 to 10.5. See three charts in the column to the right.





This unusual confluence of events is in our view symptomatic of the beginning of the combined impacts of financial repression induced by low interest rates and quantitative easing in the US and other major economies.

Our 2013 forecast return for the Australian All Ordinaries Price Index is +11.2%, with a risk around this return of 18.2%. Therefore, we expect a 66.6% probability of a return between -7.0% to +29%. Our scenarios for calculating these probability-weighted return and risk figures are shown in the table below.

Forecast Australian Equity Market Price Return & Risk

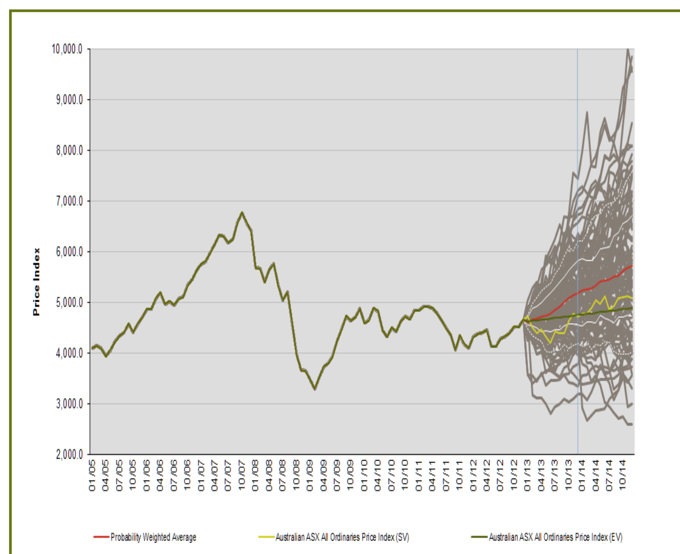
Year ended 31st December 2013	Probability	ASX All Ordinaries Price Index			ASX All Ordinaries Price Index Return		
		From		To	From		To
Units of measure:	%	Index	Index	Index	%	%	%
As at 31/12/2012			4664.6				
Scenarios [to 31/12/2013]:							
Best case	10.0%	6218.7	-	7446.1	+33.3%	-	+59.6%
Optimistic case	15.0%	5833.7	-	6218.7	+25.1%	-	+33.3%
Base case	50.0%	4569.2	-	5833.7	-2.0%	-	+25.1%
Pessimistic case	15.0%	4569.2	-	4206.3	-2.0%	-	-9.8%
Worst case	10.0%	4206.3	-	3196.9	-9.8%	-	-31.5%
Total | Probability-weighted return	100.0%		5188.2		-7.0%	+11.2%	+29.4%
Probability-weighted risk						18.2%	
Return skew [impact of quantitative easing]	65.0%		4758.8			+9.2%	

Note that this year we have presented our forecasts as a 'cone of uncertainty', which is more consistent with the way we forecast other key value drivers in our company valuation models. The best case scenario is the top 10th percentile of stochastic returns; the optimistic case the 75th to 90th percentile; the base case the 25th to the 75th percentile; and so on.

This methodology will no doubt make those clients who have read our Xmas book gift this year, The Signal and the Noise: The art and science of prediction, more comfortable with our forecasting approach.

This year we have also incorporated our estimate of the future impact of central bank quantitative easing and financial repression into our forecasts. We will send out a separate paper explaining this in more detail in the next few weeks, but suffice to say at this point that incorporating these effects biases our 2013 probability-weighted forecast by +9.2%.

The chart below illustrates the 'cone of uncertainty' for our forecasts.



Conclusion & Portfolio Positioning

In 2013 we should see improved optimism towards the global economic and financial outlook helped by the 'magic' of central banks printing money. The Euro area is making good progress with the help of the ECB, whilst China seems to be experiencing a cyclical economic upturn, whilst making the right noises about undertaking strategic reforms to put its economy on a more stable longer-term economic footing. The US economy looks set to return to stronger growth in the second half with a back-drop of excess liquidity and well capitalised corporate balance sheets, and the longer-term productivity benefits derived from low cost energy. Australia is still reasonably well positioned given its scope to reduce interest rates and should benefit from the cyclical upturn in China, although there are still reasons to be cautious given the continued high level of household debt and the increased propensity for households to save more.

We strongly believe that the increased liquidity from central banks will continue to have a positive impact on markets in the year ahead. Additionally, major tail risks appear to be abating. Debt markets are factoring in significantly lower risks around European sovereign default, which has improved access for bank funding. Finally, equity markets look cheap relative to 'crowded' low risk assets such as bonds, with the yield on government bonds at extremely low levels relative to historic norms. The incredibly low bond yields on offer have seen bond proxies attract more capital flows. High yield and low risk stocks are now expensive and we expect a move back to capital growth and higher risk stocks as global macro-economic data improves, inflation expectations rise, and risk appetite continues to increase.

Fundamentally we think the Australian equity market is moderately cheap. Going forward we expect the market to consolidate its recent gains now that the US 'fiscal cliff' has been largely resolved, but may well retract in the short term given the looming debt ceiling negotiations that are to be held in April. Beyond this, the ongoing reflation initiatives, expectations of improved business spending in the US and a cyclical upturn in China are likely to take equity markets higher for the remainder of the year.

The portfolio remains overweight energy. Energy is a growth sensitive sector that will benefit from an improvement in global economic activity, especially in China, plus tail risks such as Iran-Israel tensions will likely add to the oil price strength. The portfolios main exposure to the energy sector is through Woodside Petroleum [WPL] and Oil Search [OSH] OSH trades at close to a 30% discount to our valuation and we expect them to deliver positive news flow over the next 12 months which should see some of this discount erode. Our position in WPL also provides good exposure to a rising oil price environment. These LNG producers are somewhat insulated from the shale gas revolution occurring in the US given the difficulty in physically exporting the gas from the US and the prohibitive cost to transport the gas.. The bigger risk to the Australian LNG producers is whether China develops its shale gas resources; however this is far longer dated.

The portfolio has recently increased its overweight position in the media sector, principally through its holding in News Corporation [NWS]. NWS trades at close to a 16% discount to its valuation and has strong structural growth drivers such as strong film and DVD content which is desirable to content acquirers giving NWS's pricing power, leverage to an improving consumer market in the US that will improve cable subscriptions and a split of the traditional newspaper assets from the remaining media assets, all of which are expected to deliver growth.

The portfolio also remains overweight consumer services and insurance. The large overweight position in the consumer services sector includes stocks such as Invocare, Navitas, Tatts Group, and Tabcorp. These companies are fundamentally cheap, sell defensive products or services, and provide diversification benefits if our more bullish economic and market outlook proves to be incorrect.

Our overweight position in the insurers mainly relates to our large position in QBE, having sold down our position in Suncorp over the last quarter in to significant strength [outperformed by 13% over 2HCY12]. This outperformance followed our buying in March where we significantly increased our position during the large loss events that took place. We remain attracted to the rising premium growth cycle these companies are experiencing. In QBE's case, an eventual normalisation of the yield curve also provides significant upside given their current suppressed investment earnings from low short-term interest rates. Although these companies are currently attractively priced relative to their fundamental value, we are cognisant of the impact of longer-term inflation risks on these stocks.

We maintain our confidence in our overweight position in QBE. We consider recent announcements by the company on large claims costs and adverse reserve development of a run-off book of claims as business as usual risks for an insurer, that don't pose a material threat to future profitability or capital. Importantly we are comfortable with our forward estimates of large losses and while the reported adverse claims development has been isolated and contained, we have incorporated a buffer into our model for potential deterioration elsewhere. We therefore expect the "turnaround" story for QBE to commence during 2013. With the operating trends well disclosed, the key focus of the full year 2012 result will be balance sheet prudence and conservatism on large loss expectations and target underwriting margins for the near term.

We have increased our position in AMP as fund flows continue to recover, life insurance sales and profitability improve and merger cost savings are realised.

Another sector where we have boosted our exposure recently has been the utilities sector through exposure to AGL Energy [AGK]. AGK is benefitting from a range of structural changes that are taking place within the electricity market; more specifically related to the changes in power generation and retail market dynamics which are enhancing AGK's market power.

The portfolio remains underweight sectors that are experiencing major structural change in Australia, namely retail and domestic media.

Despite our overweight position in Rio Tinto (RIO), which has provided good leverage to the rising iron ore price, and should continue to benefit from the cyclical upturn in China, the portfolio is underweight the materials sector with no exposure to the building material stocks (Boral, Fletcher Building or James Hardie) and a larger underweight position in BHP after selling into the strength over the last quarter. The building stocks have been strong over the last two quarters on the assumption they would be big beneficiaries from a rebound in the housing market both in the US and domestically. In Australia, to date there is no evidence that the recent rate cuts are flowing through to housing starts. Our housing starts forecasts for FY2013 sit at 133k, which is below most market estimates. We believe a recovery will come but expect things to deteriorate before more government intervention kick starts the housing sector.

The portfolio also remains underweight the banking sector, the real estate sector and the telecommunications sector. These three sectors have been the major beneficiaries of the chase for yield that has characterised the market over the past year. We view the Australian banks as close to fair value at present. Our bank valuations reflect a more challenging bad debt environment, a slowing domestic economy and structurally lower return on equity in a more demanding regulatory environment. A decline in credit quality will pressure earnings, resulting in dividend cuts and a consequent reassessment by the market of their yield status. We see a sustained high Australian dollar, slowing resources growth, elevated asset prices and upward pressure on the unemployment rate as the ingredients of a weaker credit cycle.

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