JCP Investment Partners - March Quarter 2014

April 2014

We maintain our outlook that 2014 will be a year of continued, although modest, market strength for equities, driven by central banks remaining focused on avoiding deflation, encouraging employment, preserving liquidity and anchoring forward rate expectations. We believe that these efforts should continue to favour equities; however the Australian market is likely to underperform major global markets given our deteriorating domestic economy. As per our January outlook note, our 2014 forecast return for the Australian All Ordinaries Price Index was a more modest +1.8%, with risk around this return of 14.9%.

At the end of the March quarter, the Australian market remains fairly flat for the year to date, with the ASX 300 finishing up +0.70%. Our market marginally underperformed the US S&P500 (+1.3%), driven by the banking sector outperforming the resources sector following their recent benign trading updates and recent growth concerns out of China, which are impacting the miners. Moving forward we expect continued volatility for the remainder of the year, with little upside to our expected market return given our investment universe is currently over-valued.

Europe

Despite broader tensions and political risks in the Ukraine as Russian forces advanced on the Crimean Peninsula, further evidence that Europe's prolonged contraction in economic output is coming to an end emerged throughout the March quarter.

The Euro composite PMI recorded 53.2 in March and 53.3 in February, indicating expansion and the highest reading in 32 months. This has largely been driven by Germany, where industrial production [IP] recorded its third month of growth and their consumer confidence (ZEW) survey recorded its strongest response since August 2011. France also recorded its highest PMI reading in 3 years, rising to 51.6 in March from 47.9 in February.

Despite Germany and France doing the heavy lifting, those countries in the periphery dragged down the total eurozone IP growth -0.2% in March, largely due to lower energy output. The UK also continues to suffer from elevated unemployment with the current rate sitting at 7.2%.

From a portfolio perspective we remain less cautious on companies with eurozone exposure.

United States

Despite some fairly severe weather conditions throughout their winter, the US economic recovery appears to be on track. IP increased +0.8% versus expectation of +0.1%. Non-farm payrolls increased 175k in February, and the January reading was revised higher, resulting in an unemployment rate of 6.7%, which continues to improve from the 7.0% recorded late last year. Housing starts continue to bump along the bottom, with 907k starts recorded last month.

These improved signs led to the Fed cutting their bond purchases by another $10bn to $55bn per month recently. They also advised that the benchmark federal-funds rate will remain near zero for a "considerable time" after its asset-purchase program ends, which probably implies 6 months or so after the full removal of QE. The Fed have also elected to drop the unemployment rate as a definitive yardstick for measuring the strength of the economy, suggesting a preference to rely on other factors in deciding whether to boost interest rates, and anticipate the unemployment rate is likely to hit 6.1% - 6.3% by the end of this year given the current trajectory.

Inflation is likely to rise gradually toward the central bank's 2 % target, despite recent readings well short of that objective. We believe that until inflation appears to be out of the Fed's control, the market is likely to remain accepting of the stimulus. Despite the slightly more hawkish Fed and the fact that global liquidity conditions have become slightly less supportive, we remain in an incredibly accommodative environment for equities. Central Banks will continue to pump liquidity in to the world economy, just at a lower rate.

Earnings growth in the US should also pick up this year due to stronger activity both within and outside the US economy. Consensus EPS growth estimates for the US are +8.4% for this year, with scope for revenue upgrades driven by improved employment conditions, household debt burdens being reduced and continued exceedingly low interest rates,

From a portfolio perspective, we continue to favour companies leveraged to the US economy, particularly those that can benefit from this incredibly accommodative environment.

China

We have been consistent in our view for some time now that China is experiencing a structural slowdown, albeit at a gradual pace. Our recent travels to China have reaffirmed this view, although some aspects of China's growth are of greater concern to us than previously thought.

It is well known that the Chinese Government has embarked on a strategy to transition its economy from an investment led economy to one that is consumption driven. This was strongly emphasised during our Head of Resources' (Peter Harris) recent trip to China where feedback suggested the Government stance is supportive toward funding consumer focused activities, with plentiful credit available for health, commerce and recycling industries. Conversely, credit for steel, ship building, cement or any industry suffering from over-capacity is difficult to obtain.

The steel industry in China is incredibly important to the Australian economy given the demand for iron ore and met coal that feed into steel production. Chinas' steel industry is unprofitable and suffering from over-capacity. Given this over-capacity and worsening environmental issues, the Government is forcing steel mill closures, specifically enforcing smaller, high-polluting mills to close, due to not being able to comply with more stringent environmental controls. This major restructuring in the Chinese steel industry will take 2-3 years and has only just begun.

Given this restructuring, most steel mills we have spoken to believe steel demand will be flat to down in 2014. This compares to the +8% growth in 2013 (779m tonnes) and the +3% growth in 2014 (to 810m tonnes) forecast by CISA, the Chinese Iron and Steel Association.

Our most recent feedback suggests that peak steel in China may actually be now, implying a weakening demand outlook for iron ore moving forward. This outlook is consistent with our long run iron ore forecast of US$77/ tonne, although the trajectory to which we reach our long run price may be steeper.

Despite the Chinese Government recently reiterating their GDP growth forecast of 7.5%, these restructuring initiatives are being felt in the broader Chinese economy with a recent weak IP reading, lower export data, (down 18.1% yoy in February, the worst since August 2009) and the recent PMI reading at 48.1, indicating contraction in manufacturing.

From a portfolio perspective, we are considering the trajectory to our long run iron ore forecast in light of our recent findings in China.

Australia

The Australian economy faces a number of major challenges in the years ahead. Lower terms of trade will have a negative impact on gross national income. There will be a significant hole in private sector business capex that will be extremely difficult to fill, especially given Australia's current competitiveness problems (e.g. labour costs, excessive regulation, etc.). Higher investment in private sector non-business capex (housing and real estate) is how most economists fill this whole, but the growth rates required to do so seem very high relative to historic growth rates in this sector.

We also think that policy tools (fiscal and monetary) have been 'over-spent' leading into this challenging economic period. Although Australia's fiscal position is still far better than many other developed economies, it has unnecessarily and materially deteriorated over the last five years due to excessive Government largess for largely political reasons. This will compromise policy potency over the next few years.

Recent economic data reinforces our view above. Despite some sample rotation distortion that contributed to an unusual jobs surge in March, unemployment remains at a 10½ year high. The recent NAB Business Survey suggested that business conditions retraced and labour market conditions remain weak, whilst consumer confidence has now fallen 10% since September as a weak labour market weighs on households. Additionally, the number of housing finance approvals was slightly weaker than expected during the last quarter, though the composition was arguably quite positive. Specifically, approvals for new construction continues to rise strongly (+5.8% mom and +22% yoy). Housing construction remains a bright spot for the domestic economy, which was confirmed by Boral during reporting season, who benefitted from improving housing construction for their building products division.

Despite the weaker outlook for the Australian economy, our market is likely to be dragged modestly higher over the year by offshore markets, but it is likely to underperform major global markets.

Reporting Season Wrap

The February reporting season was generally subdued, with flat to single digit top line growth a common feature. This saw the market heavily reward companies that posted stronger revenue growth [Carsales.com, Ramsay Healthcare, Seek, and RealEstate.com]. A notable emphasis on cost control assisted in delivering earnings guidance.

Full year consensus 2014 earnings forecasts have been revised up 1.5%, with the market expecting +8% growth (versus JCP: +4.5%), although revenue forecasts have actually been cut, the bulk of earnings upgrades coming from the resources sector.

Commentary and outlook was typically cautious given consumption weakness, and little evidence of a broad based recovery in retail trading conditions. Mining austerity continues to weigh heavily on many industrial companies. The Bank trading updates have suggested asset quality continued to improve assisted by record low interest rates and historically low levels of corporate leverage.

Portfolio Positioning

Fundamentally we think the Australian equity market is now moderately over-priced relative to our assessed fundamental value (-6.9%).

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

The major underweight sectors for the portfolio are: Banks, Food & Drug Retailing, Food Beverage & Tobacco, Real Estate, Utilities and Transportation.

Wes Campbell
Head of Institutional Business & Senior Portfolio Manager
wes.campbell@jcpip.com.au
+61 3 9607 4117

THIS MATERIAL IS INTENDED FOR USE SOLELY BY INSTITUTIONAL INVESTORS. STRICTLY NOT FOR PUBLIC DISTRIBUTION.

The information contained in this brochure is general information only. It has been prepared without taking into account specific investor objectives. You should assess whether this investment us suitable for your specific investment objectives and seek professional advice before deciding to invest in the product. JCP Investment Partners cannot guarantee the success of our return of capital of any investment in this product. Information contained herein is accurate at the date of issue. JCP Investment Partners LTD, Level 23, 600 Bourke Street, Melbourne, Victoria, 3000. ABN 23 085 400 540. AFSL No. 247132

jcp INVESTMENT PARTNERS
combining the art and science of investing