JCP Investment Partners - Market Outlook 2014

January 2014

2013 was a strong year for global equity markets, with the MSCI world index finishing up +23.7%. The Australian equity market finished the year +15.1% (ASX 200), its strongest year since 2009. However, our market underperformed the US (+29.6%), Europe (+16%) and Japan (+56.7%), although China was weaker (+3.6%). These strong returns across world markets were driven by a combination of extremely accommodative monetary policy settings and synchronised global growth. While there are many major economic and financial risks that could eventuate (e.g. political breakdown in Europe, a disorderly and rapid increase in rates, US congressional instability, etc.), we expect 2014 to be a year of continued, although more modest, market strength for equities. Our optimism is centred around central banks remaining focused on avoiding deflation, encouraging employment, preserving liquidity and anchoring forward rate expectations. These efforts should continue to favour equities, however the Australian market is likely to underperform major global markets given our deteriorating domestic economy.

Europe: Prolonged contraction coming to an end

The European economy remains enormously important to the global economy, with output representing 18% of global GDP. Although structural problems persist, such as whether the ECB will become the single supervisor for banks moving forward, the prolonged contraction in economic output is coming to an end.

A fall in borrowing costs alongside the easing of credit has laid the foundation for an economic recovery. The ECB has put in place measures to restore business and investor confidence and as global growth improves over the next year, trade oriented Euro countries stand to benefit. Improvements to foreign trade, business confidence and financial stability in Europe will help boost global growth.

Hopes for better economic performance depend more on an improvement in the core economies as it is unlikely banks in the periphery will face much credit demand given the weakness in their economies.

Political risks remain in the region and whilst the single currency is not under threat today, its future will depend on whether high unemployment rates in the peripheral economies can be reduced to acceptable levels.

From a portfolio perspective we are less cautious on companies with euro zone exposure.

China: Restructuring to achieve sustainable growth

Our view on China remains that they are experiencing a structural slowdown, albeit at a gradual pace. Recent reforms announced at the plenary session last November are aimed at tackling some of their longer term challenges such as adverse demographic trends, the need to orient growth more towards domestic consumption, the need to liberalise the financial system and improve the environment.

The many reform initiatives outlined at the Third Plenum are designed to help ensure that growth can be maintained in a more measured and controlled manner. The supply side restructuring initiatives, such as reducing the over-capacity in the steel industry, are designed to increase longer-term sustainable growth potential; however they are unlikely to result in a short term growth reacceleration like we have seen historically from various stimulus measures.

The implementation of the Third Plenum will start soon, with a focus on solving capacity issues, innovation, getting local debt under control, the next phase of China's urbanisation and the continual opening up of the Chinese economy, such as interest rate liberalisation and the opening of the capital account. Whilst the Chinese Government will not release its forecast for GDP growth until March, it is clear that the new leadership's focus is on restructuring with an emphasis on developing the economy with an environmentally sustainable solution. The environment in China is a social issue that has become a major economic and political problem given poor air quality. This is a major reason behind our structural negative view on the thermal coal industry.

The steel industry in China is incredibly important to the Australian economy given the demand for iron ore and met coal that feed in to steel production. Whilst steel production increased 8% in 2013 in China, our proprietary contacts suggest that steel production growth will remain relatively buoyant: +5% to 6% in 2014 as the Chinese property market is still relatively strong and the over-capacity supply side restructuring initiatives will take time to implement. This will likely keep iron ore prices above $110 p/t this year.

From a portfolio perspective, we continue to favour low cost bulk commodity producers as well as the education and tourism sectors that can provide exposure to the increasingly affluent Chinese consumer.

United States: Cyclical bull market remains intact

Much of our bullish outlook for markets last year related to the US economy and the impacts of a rapidly expanding US money base. Whilst the Fed has recently begun the tapering process by reducing the purchases of Mortgage Backed Securities by $10bn per month, we remain in an incredibly accommodative environment for equities. Central Banks will continue to pump liquidity in to the world economy, just at a seemingly lower rate.

Until inflation appears to be out of the Fed's control, the market is likely to remain accepting of the stimulus. This will certainly be the case now that newly-appointed Fed Chair, Janet Yellen has suggested that inflation can rise to 2.5% and higher to compensate for the below par rate that has prevailed for so long. This is great news for equities.

It is clear that the aim of the Central Bank has been to hold asset prices up with the use of QE until the real economy caught up and could take over the heavy lifting. To that point, the US economy is beginning to show some renewed strength, with ISM new orders for US manufacturing businesses improving.

The labour market is also improving, with November non-farm payrolls of 203k versus estimates of 180k and the unemployment rate falling to 7%.

The housing sector has also shown signs of strength with November housing starts rising 22.7%, the highest in 5 years. This improvement in the underlying economic data and a reduced fiscal drag this year, should see the US economy grow by around 3% this year versus the below 2% in 2013.

Earnings growth in the US should also pick up this year due to stronger activity both within and outside the US economy. Exceedingly low interest rates, lack of bargaining power in the labour market and a surge in productivity will be key drivers for earnings expansion. The lack of bargaining power in the labour market is an interesting point. Owners of capital have managed to capture a growing share of income over the past several years. Moving the US to a sounder foundation, where rising incomes lead to increased spending and thus further gains, is going to be hard to achieve without faster growth in real wages. As labour markets tighten, companies will have to pay higher wages to attract workers, but this is still some time away.

Growth in the US should be fairly broad based. Corporate spending should increase given the historically low levels seen in the recent years. Consumer incomes and spending will benefit from steadily rising employment. Some improvement in exports should occur from firmer growth in the rest of the world.

Despite US markets trading at all-time highs it would appear that valuations are not at levels that preclude markets from moving higher, (The MSCI World Index is trading on a 12 month forward PER of 14.6x, below its historical average of 15.8x). It is our view that the cyclical bull market in the US remains intact. We are still in an environment where monetary conditions are hyper stimulative and inflation is extremely low and corporate profits can accelerate further. This type of environment encourages asset bubbles, and while it continues, US stocks will trend higher.

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

Australia: Not synchronised with global recovery

Despite the immensely accommodative conditions for risk assets seen globally, the Australian economy is not well synchronised with this.

After two consecutive years where the Australian market has been driven by P/E expansion, in the future it will have to earn its gains by delivering stronger growth. The domestic earnings outlook appears challenging due to a weaker consumer, against a backdrop of slower growth in national income, impacted by a declining terms of trade. More rate cuts are needed with higher unemployment a key risk to the economy. However it appears the RBA's preference is for a lower AUD via jaw-boning tactics rather than additional rate cuts.

Australian manufacturing conditions remain very subdued, with the December PMI falling to 47.6. The initial lift in sentiment around the Federal election was short lived, with manufacturers signalling little relief from the easing in the AUD, ongoing import competition and poor external demand for exports. Additionally, consumer confidence dropped 4.8% last month.

On the earnings front, expectations for FY14 domestic earnings have been cut over the past quarter. The market is now expecting earnings growth of 6.8% versus 8% last quarter (JCP expects 3.3% earnings growth in FY14). Industrials have been cut 8% in the past 6 months and are now heading towards zero earnings growth. Resource stocks have seen upgrades thanks to a declining AUD and cost out initiatives. Should commodity prices stay around these levels, the resources sector stands to be a large beneficiary of their ongoing cost-out programmes and the weaker AUD.

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.

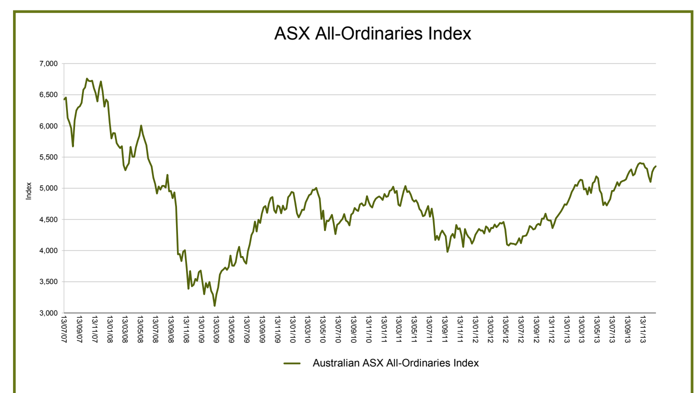
Australia: Equity Market Outlook

Last year we forecast a +11.2% price return for the Australian All Ordinaries Price Index, with 18.2% 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 Price Return & Risk

		ASX All Ordinaries Price Index			ASX All Ordinaries Price Index Return		
Year ended 31st December 2013	**Probability**	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%	

The All Ordinaries Price Index returned +14.8% (within our forecast range of -7.0% to +29.4%). See below chart.



The confluence of events that influenced equity markets over the last 12 months is in our view symptomatic of the continued impact of financial repression induced by low interest rates and quantitative easing in the US and other major economies.

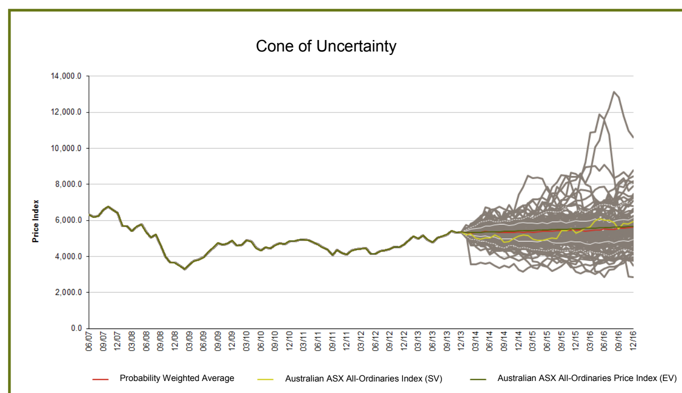
This easy monetary policy and excess liquidity led to greater investor confidence in global corporate earnings growth and less negative 'tail risks' in regions such as Europe, Japan, and China.

Our 2014 forecast return for the Australian All Ordinaries Price Index is a more modest +1.8%, with a risk around this return of 14.9%. Therefore, we expect a 66.6% probability of a return between -13.1% to +16.7%. 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 2014	Probability	ASX All Ordinaries Price Index From		To	ASX All Ordinaries Price Index Return From		To
Units of measure:	%	Index	Index	Index	%	%	%
As at 31/12/14			5354.9				
Scenarios [to 30/04/2014]:							
Best case	10.0%	6519.1	-	8571.6	+21.7%	-	+60.1%
Optimistic case	15.0%	5999.8	-	6519.1	+12.0%	-	+21.7%
Base case	50.0%	4794.2	-	5999.8	-10.5%	-	+12.0%
Pessimistic case	15.0%	4794.2	-	4272.7	-10.5%	-	-20.2%
Worst case	10.0%	4272.7	-	3157.3	-20.2%	-	-41.0%
Total | Probability-weighted return	100.0%	4654.8	5453.1	6251.4	-13.1%	+1.8%	+16.7%
Probability-weighted risk						14.9%	
Return difference versus expeced return			5530.8			-1.5%	

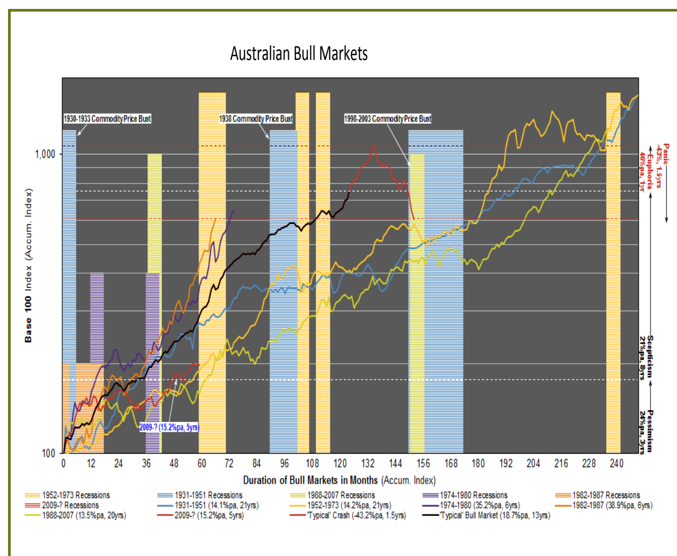
We also show below our forecasts as a 'cone of uncertainty' for the next three years. The best case scenario is the top 10th percentile of stochastic returns; the optimistic case the 75th to 90th percentile; the base case the 25th to the 75th percentile; and so on.



Despite our cautious view over the next 12 months given that we see the Australian market at fundamentally expensive (i.e. 5.7% over-priced) from a bottom-up perspective, we are still longer-term very bullish.

In bull markets confidence drives fundamentals higher via increasing business investment and innovation, which in turn drives employment, household incomes, consumer confidence and spending, and ultimately business profitability and equity markets.

This demonstrates the reflexivity that exists in equity markets. This virtuous cycle is illustrated in the following chart which shows Australia bull markets for the last 100 years and plots the progression of the post 2009 bull market.



Conclusion & Portfolio Positioning

In 2014 we expect a combination of continued low interest rates and sufficient improvement in economic activity to deliver earnings gains, which should provide a bullish outlook for equities, particularly in the US. We expect our market to be dragged higher over the year by offshore markets, however it is likely to underperform major global markets. Whilst equity markets do not appear cheap, accommodative conditions are still in place allowing markets to overshoot and earnings to catch up, which is typical of bull markets.

The Euro area is experiencing diminishing fiscal drag and modest growth in 2014 which will help it climb out of recession and ensure that the prolonged contraction in economic output comes to an end. China is pressing ahead with restructuring initiatives to achieve sustainable growth. The US economy should gain momentum into 2014 and achieve better growth. It is our view that the cyclical bull market in the US remains intact.

We are still operating in an environment where monetary conditions are hyper stimulative and inflation is extremely low, and also where corporate profits will accelerate. This type of environment encourages asset bubbles, and while this environment continues, US stocks will trend higher. The Australian economy is not well synchronised with this.

The outlook appears challenging due to a weaker consumer against a backdrop of slower growth in national income, impacted by a declining terms of trade. A weaker AUD is not helping the manufacturing sector as yet, although provided commodity prices stay at these levels, the weaker AUD and cost out initiatives will benefit listed resource companies.

The accommodative easy money should remain bullish for risk assets as long as there are no major negative shocks. Valuations are not cheap, but neither are they worryingly high. Many companies have maintained a tight focus on keeping costs under control over the past year or two.

JCP Investment Partners – Market Outlook 2014

January 2014

For the global cyclical companies it should get easier for earnings if global economic growth improves. Resources should also benefit from their cost out initiatives and a weaker AUD. Domestic cyclicals should suffer given the deteriorating Australian economy and bond proxy defensives should underperform as bond yields begin to rise along with global growth expectations.

Fundamentally we think the Australian equity market is now overvalued (~5%). We believe consensus earnings for FY14 are too high, which will likely result in some downgrades throughout the first 6 months of the year, particularly for the domestically focused cyclicals.

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

The major underweight sectors for the portfolio are: Banks, Food & Drug Retailing, Telecommunications Services and Health Care Equipment & Services.

We continue to see greater value in the energy, materials, insurance and US Dollar exposed industrial companies are present.

JCP Investment Partners: Core Values

Client focus

We act as investment agents for our clients: our fiduciary responsibility to them is our primary concern.

Team work

We work in teams that encourage respectful debate and critical review to promote objective and astute decision-making.

Initiative

We seek insightful information and efficient processes from which to build real competitive advantage.

Sustainability

We recognise the need to weigh short-term economic gains against long-term ethical, social and environmental impacts.

For further information please contact:

Michael Fitzsimmons
Chief Investment Officer
michael.fitzsimmons@jcpip.com.au
+61 3 9607 4101

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