JCP Investment Partners - September Quarter 2015

October 2015

At the end of the September quarter, the Australian equity market (All Ordinaries Price Index) is down 6.12% for the calendar year to date. Our market weakened during the September quarter by -7.2%, with the All Ordinaries posting its second consecutive quarterly loss for the first time since 2011 as concerns over a weaker outlook for China and a deteriorating domestic economy spooked our market. Offshore markets were also weaker, with the US S&P500 (-6.9%), UK FTSE (-7.0%) and China Shanghai (-28.6%). In Australia, Industrials **(+2.4%)** and Utilities **(+1.3%)** were the two best performing sectors for the quarter, whilst Energy **(-25.9%)** and Materials **(-12.8%)** were the two worst performing, with the Financial sector also underperforming **(-9.1%)**.

The quarter was characterised by heightened volatility, largely attributed to global themes; concerns over Chinese growth alongside the timing of US interest rate hikes. The volatility in markets throughout the last quarter has been the most extreme since the later periods of the GFC. Despite the equity market pullback, our valuation universe implies the market is only around fair value, largely because of the elevated risk (VIX) in the market, that feeds in to our dynamic equity risk premium (ERP).

United States

We remain positive on the US economy. The FOMC's opening remarks (Sept 2015) suggests to us that their view is consistent with our positive outlook.

"Information received since the Federal Open Market Committee met in July suggests that economic activity is expanding at a moderate pace. Household spending and business fixed investment have been increasing moderately, and the housing sector has improved further; however, net exports have been soft. The labor market continued to improve, with solid job gains and declining unemployment."

This is essentially the background for our tilt toward US exposure in the portfolio. In our view, the US economy continues to display healthy momentum, evident in solid employment, construction activity, and consumer spending.

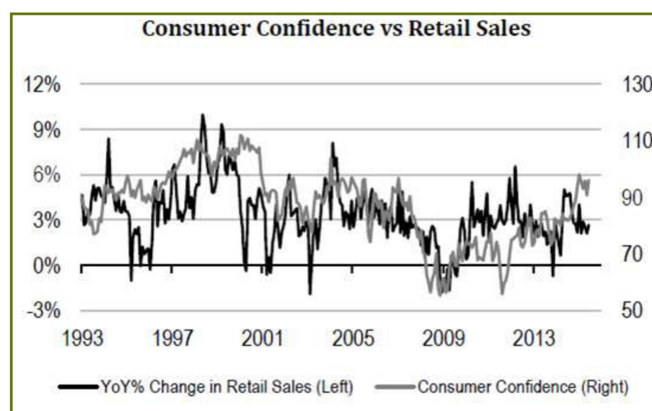
Whilst the latest employment data has been weaker than expected, our proprietary feedback on the ground in the US suggests that whilst wage growth is patchy across industries and sectors, it remains strong in parts. E.g.: we learnt on a recent trip to the US that the housing and construction industry is already suffering labour shortages at 1.1m housing starts. Whilst wage inflation in manufacturing is running at 2.5 - 3%, in the housing trade (e.g.: roofers etc.), workers are experiencing higher wage growth of 7-8%.

Analysis of the latest job reports, highlight the negative impacts of aging and long-term unemployment on wages growth and participation. These factors are usually considered part of a discussion around the "new" NAIRU. As the share of long-term unemployment and the number of part-time workers for economic reasons continues to fall, we expect additional wage pressures to filter through to the broader economy.

Rising wages should in theory to lead to a rising Federal Funds Rate, however the FOMC met and left rates unchanged at their September meeting, largely due to concerns over global growth, specifically China and emerging markets.

There are also warnings signs in the US: leading indicators of exports (due to the stronger USD) and energy (weaker oil price) are softening. There is, however, one important offset: the pick-up in residential activity. On our recent US trip we learnt that the acceleration in housing is likely to continue, with housing starts expected to increase by 12-14% in CY16 (versus expectations of 8% a few months back). Loan data points to the strongest increase in demand for mortgages in 10 years, which should translate to further growth in housing starts, supporting confidence that the US housing recovery is coming through.

US 2Q GDP growth was recently revised upwards from 3.7% to 3.9%. The revision was driven by consumer spending being stronger than initially expected due to rising wages, falling gasoline prices and falling interest rates. These factors are contributing to improving consumer confidence; now the highest in a decade (illustrated in the below chart).



Source: Deltec

The boost to consumer confidence should lead to stronger retail sales growth, as was demonstrated by the stronger retail sales in August (including upward historical revisions). Ultimately, consumption will lead to an increase in new orders and increased profitability; such is the virtuous circle of economic activity in the US.

Despite the volatility in the US jobs data, and commentary by the FOMC, we continue to favour companies leveraged to the US economy and a strengthening US dollar, supported by our view that the underlying economy is moving in the right direction.

China

We continue to assess China from two perspectives: i). China as a whole, and ii). China's impact on Australia's economy.

For **China as a whole,** our recent trip to China provided further evidence that their economy is slowing with few signs of the reforms required actually being implemented. Four major themes emerged:

1. Industries remain burdened with overcapacity and are increasingly looking to export excess volumes

Steel mills expressed the view that the local steel industry is

"dead" and they expect a recovery to be at least 3 years away. The Chinese thermal coal industry may return to being an exporter, with Chinese players having their eye on displacing the Indonesian coal market.

2. Despite overcapacity, limited closures are in sight given high barriers to exit

Significant barriers to exit exist across many industries. Such barriers exist to ensure workers remain employed and SOEs remain relevant. Bureaucratic procedures, such as government signoff and various incentive structures, like capital allocation based on levels of production rather than profitability, ensure that adjusting the cost structure, such as the labour component is very difficult. Another barrier to exit is the banks. A number of the government owned banks don't want to shut down production at many of these heavy industries because this will trigger the realisation of bad debts.

3. Widespread expectation that 2016 will be a challenging year, but hope for improvement in 2017

Companies were far more bearish than expected, particularly in regards to the short term, with a lack of visibility beyond the next 12 months. At best, companies were hopeful of improvement in 2017, however this appeared to be purely hope rather than anything more fundamental. Property developers are carrying up to 2.5 years of inventory in residential and 5 years for office property.

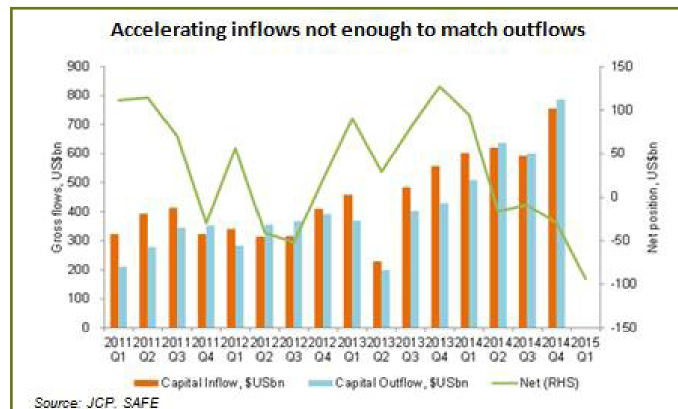
4. Transition to consumer/service economy more advanced than expected

Despite the bearishness in the commodity based industries, China's transition to the consumer and services economy is clearly under way. Wanda Properties expects to open 1 new plaza every month across China, with an expectation of 100% occupancy and strong rental yields given 4.5m people per day visit Wanda sites.

The 13th 5 year plan is expected to be handed down in November/December, which will be interesting to assess how the Central government plan to address these challenges. It is expected that policy makers will lower China's growth target and rely more on fiscal policy to stabilise the economy.

In regards to **China's impact on Australia's economy**; we are certainly more bearish on commodities, specifically, we have lowered our forecasts for coal: both thermal and coking. Additionally, we have lowered our aluminium forecasts, especially alumina and also mineral sands, however the outlook for copper appears ok. The strategy to maintain portfolio exposure in resource companies on the lower end of the cost curve with strong balance sheets continues to be a key area of focus, especially in a climate of forced capital raisings and asset divestments.

Another area of focus has been on capital flows. Beijing has attempted to clamp down on capital outflows given China's foreign exchange reserves have fallen to an estimated $US3.5 trillion ($5 trillion) from last year's peak of about $US4 trillion. We think the decision by the PBOC to devalue the RMB has been as much to do with capital flows as it has to do with trade flows.



Source: JCP, SAFE

The above chart shows the ongoing increase in inflows and outflows supporting the Chinese economy through 2014. It is tempting to concentrate on the net figure and its deterioration, as large outflows and declining reserves get the headlines.

The majority of growing capital inflows continues to be foreign currency loans. Whereas, changes in foreign direct investment have been minor. To date the world appears to have been happy to counter the growing capital outflows from China with increasing inflows. When the Chinese economy is growing, inflows not matched by equivalent outflows, have assisted the PBOC with their exchange rate fixing and provided liquidity to the banking system.

External financing by Chinese firms and banks also made sense from a cost of funding perspective, and the 'carry trade' on RMB appreciation provided further impetus for inflows.

However the outflows (also predominantly loans, but augmented by trade credit imbalances and cash) have grown even faster. The drivers of outflows (of which Australia has been a major beneficiary) include diversification, migration, and probably a safe-haven for ill-gotten gains.

China has notionally had a closed capital account, but capital outflows seem to have been tacitly approved by the Chinese authorities, probably to alleviate the historic upward pressure on the yuan.

The risk around Chinese capital flows could prove to be problematic if the world stops extending credit to China, increases its funding cost, or the perceived value of existing loans deteriorate. The outflows may no longer be 'compliant and orderly', draining the economy of funding, and forcing further devaluation. Alternatively, the 'free flow' of capital may be interrupted for political reasons as seen recently in the Chinese stock market.

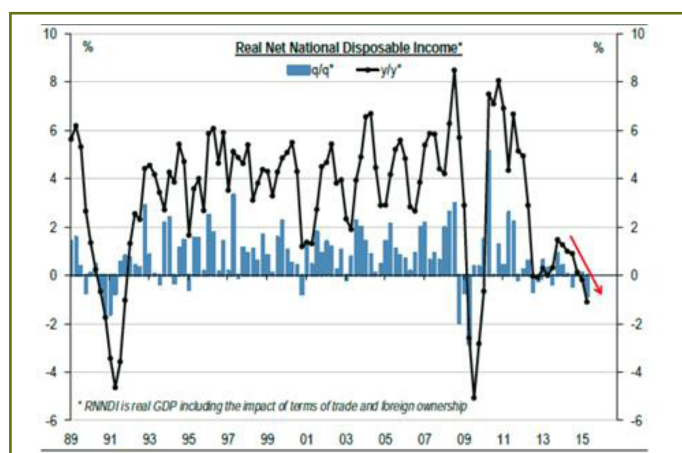
For Australia, at the tail-end of a commodity boom and not having had a recession for 23 years, it is tempting to downplay the role of capital flows in Australia. We might self-delude ourselves that the capital inflows we need from places like China will always be there. Just like China, Australia has increased its dependence on foreign capital flows, not only to fund productive mining and energy investment, but also overpriced unproductive housing investment and speculation, driven by a China inspired terms of trade boom.

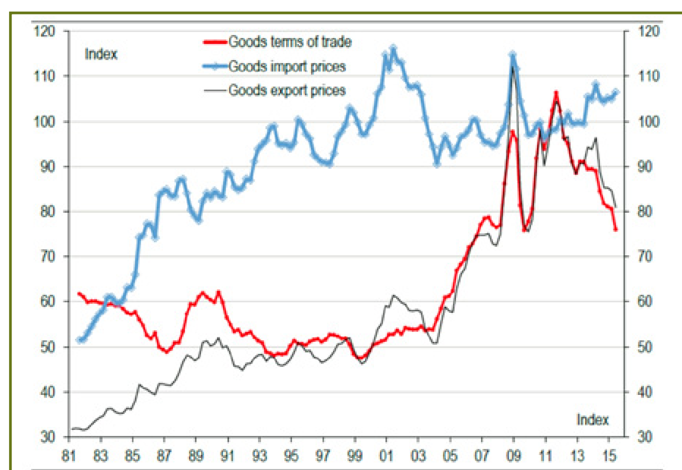
From a portfolio perspective, we are increasingly more cautious on exposure to China, particularly materials exposure in light of our findings on our recent trip.

Australia

Australia continues to face a very challenging economic environment over the next few years. Some of the key challenges include: a rapidly falling terms of trade, weak domestic demand, weak household disposable income, slowing growth in net migration, weak business investment, a deteriorating fiscal position, limited scope for further monetary policy stimulus, tightening credit standards pressuring marginal borrowers and unemployment already emerging in certain geographic regions.

One of our key areas of concern is **weak disposable income.** The Q2 National Accounts confirmed that our income recession continues (illustrated in the charts below), impacted by the decline in the goods terms of trade, which slumped 5.7% qoq in Q2 as export prices fell 4.4% and import prices rose 1.4%.

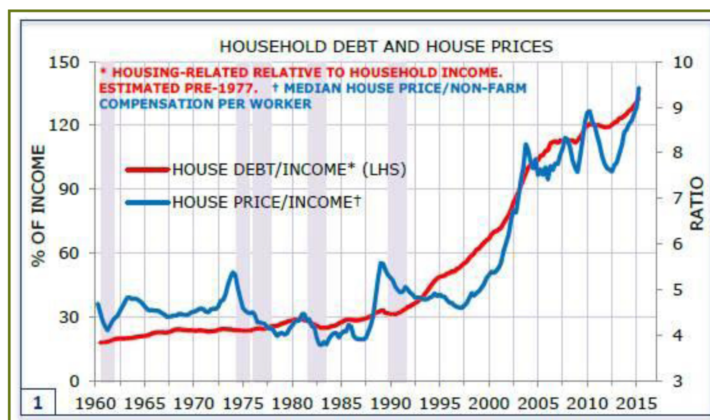




Sources: UBS, ABS

Our other key area of concern is the level of household debt and the associated tightening of credit standards pressuring marginal borrowers.

As illustrated in the following chart, household debt to income levels are at unprecedented levels.



Source: Minack

Housing has certainly been the sector keeping Australia afloat post the mining boom; however the sector appears to have peaked as regulators apply restrictive measures. Macro prudential policy tightening (10% investor loan limit), tighter lending standards, interest-only loans being discouraged by regulators (especially for owner-occupiers) and the repricing of credit (up to 100bp on the front book for investment loans) are all expected to negatively impact house prices and the demand for credit.

Construction looks to have peaked, with building approvals weaker in August, recording their equal largest monthly decline in almost a year and annual growth decelerated to +5.1%yoy, the lowest level since October 2014 - well down on +19%yoy averaged through H1 2015. As such, the impetus for GDP growth from the housing cycle is fading and replacing this source of growth looks increasingly challenging.

Consumer sentiment is also turning, with the September survey recording the third largest fall in the past four months. Fundamentally, poor sentiment is consistent with weak growth in Australian household incomes, the contraction in retail sales in July, and the negative news flow on domestic demand. These domestic constraints are unlikely to resolve in the near term.

We see an elevated risk of a recession ahead. The combination of weak disposable income and high household debt is concerning, particularly given Australia may have to raise interest rates in the future to follow the US. This is because the trajectory of US interest rates largely determines the interest rate cycles for most other economies, especially for small, open, foreign capital dependent economies such as Australia.

From a portfolio perspective we have continued 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.

Reporting Season Wrap

Four key themes emerged from the August reporting season:

1. Top line revenue growth is hard to find, particularly for those exposed to the domestic economy. The general economic backdrop has meant that organic revenue growth has been fairly

anaemic, with low single digit growth the norm. Many companies have looked to acquisitions to deliver growth.

2. Where growth exists, companies need to invest to get it. Companies such as Seek (SEK), Invocare (IVC), CSL, Brambles (BXB) and Trade Me (TME) are actively investing for future growth. The market is not rewarding this (preferring shorter term 'sugar hits', such as returning capital to shareholders) potentially presenting an opportunity for longer term investors.

3. Significant cost out and working capital improvement across all resource stocks, but the trend is easing amongst industrial stocks. Taking costs out of their businesses has been a major theme running through the last few reporting seasons, which has been particularly important given the tough revenue growth environment. It is evident from this reporting season that removing costs is a means to arrest profit declines rather than to grow profit.

4. Bad debts have turned and capital raisings have begun. We have seen deterioration in bad debts, especially in areas related to mining, agriculture, WA mortgages and personal loans. What was once a positive contributor to bank earnings growth has turned and is becoming a headwind. We have seen equity raisings by all the major banks now, the first of many more in the future we believe.

Additionally, forward looking guidance/outlook statements have generally been weak, with earnings downgrades prevalent, reflecting a slowing domestic economy. It is clear that many companies will find the road ahead challenging given the difficulty in attempting to remove further costs from their businesses.

The broad economic trajectory will ensure top line growth remains relatively modest. FY16 consensus growth expectations have now fallen below FY15 levels (-3.45%), driven by lower earnings profiles in the Energy and Materials sectors.

Portfolio Positioning

This recent reporting season has further strengthened our view that our portfolios should continue to be positioned for:

1. Weakness in the domestic economy – having little or no exposure to the Banks and Retailers, and

2. An improvement in the US economy (and a strengthening in the US Dollar)

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

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

Conclusion

The recent reporting season has further strengthened our view that the portfolios should continue to be positioned for the emerging weaknesses in the domestic economy and an improvement in the US economy. The portfolio is well positioned for the economic headwinds we see facing the Australian economy over the next few years, whilst we continue to exploit a number of fundamental valuation versus pricing anomalies that exist in a number of stocks and sectors.

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