JCP Investment Partners – March Quarter Outlook 2016

April 2016

At the end of the March quarter, the Australian equity market (All Ordinaries Price Index) was down -3.6% for the calendar year-to-date. A volatile quarter saw the equity market rally +6.5% from the February lows and +4% for the month of March. A multitude of factors drove this volatility, including; central bank action/inaction, concerns over Chinese growth, oil posting its first positive quarter in the last three, and a sharp rally in iron ore (+23% and +40% from its February lows). Global Financials had their worst first quarter since the financial crisis, with Australian banks all large underperformers driven by fears of rising bad debts. Amongst the volatility gold performed well with a price rally of 16%.

The Australian equity market underperformed both the US (S&P500 +0.8%) and the UK (FTSE -1%) while Asia was weaker with Japan (Nikkei -12%) and China (Shanghai Composite -15%) both falling substantially. We expect our market to remain volatile but grind higher throughout the remainder of 2016. We are forecasting a total return of +1.8% (with a risk number of +/-11.8%). Our expectation is also that Australian equities will continue to underperform global equities. This relatively modest growth expectation reflects our view that the Australian market is currently only slightly cheap.

United States

Stronger employment, housing, and inflation; wages the missing ingredient.

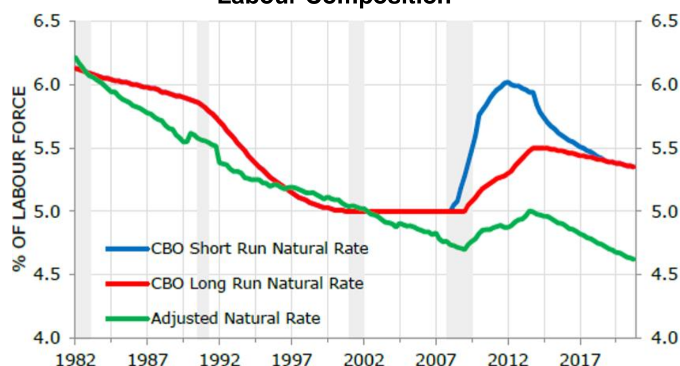
Despite the recent dovish commentary from the Fed (which suggests there is no urgency to hike rates) we are encouraged by the recent improvement in the macro data, and especially inflation. The FOMC's dovish tone was reflected in modest downward revisions to near-term forecasts, retaining language about global and financial risks, continuing to monitor inflation, and most notably, dropping the likely number of rate hikes this year down to just two (from four). New Fed projections imply that the Benchmark Rate creeps up to 0.875% by the end of 2016. They expect this to be 1.875% by the end of 2017 and 3% by the end of 2018 (both lower than their previous quarterly projections). In the long run, the Fed expects this rate to reach 3.25% (previously 3.5%). These lower 2016 rate hike expectations have helped extend the risk rally in markets.

In our view, the change in Fed rhetoric is not consistent with the data points coming out of the US. Inflation has risen more than expected and the labour market has tightened further. Real consumer spending remains strong with retail sales growing above trend. Industrial production (outside the Mining, Utilities, and Energy sectors) is expanding, and the contracting components (listed above) should soon stabilise given recently increased energy prices, and a weaker dollar.

US employment growth was better than expected in both February and March. Non-farm payrolls rose by a healthy 215,000 (in March) and 242,000 (in February), with the gains from the previous two months, being revised upward by 30,000. The labour force increased by 1.5 million in the last quarter, leaving the unemployment rate at 5.0%. Wages growth remains the sticking point, with average hourly earnings in March increasing by 0.3% month-on-month, an improvement on the 0.1% decline in February. However, the annual growth rate is still at a reasonable level of 2.3%.

Overall, labour market conditions are healthy. The lack of a material pick-up in wage growth is the only missing ingredient to a stronger US recovery. One reason wages growth is yet to accelerate is the debate around the non-accelerating inflation rate of unemployment (NAIRU).

Chart 1: US: NAIRU Adjusted for Changing Labour Composition

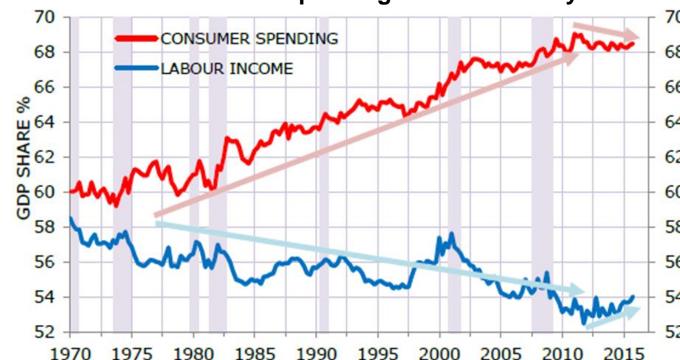


Source: Minack

There is a now a view that the NAIRU is now lower, based on work by the Chicago Fed that suggests that NAIRU could be more like 4.5% to 5.0%. Given we have not yet reached this point, significant wage growth may take more time to come through. We suspect that the unemployment rate may need to overshoot downward before wage inflation accelerates.

Business seems to have plenty of capacity to pay higher wages. The chart below suggests labour income as a % of GDP has bottomed and is now beginning to head higher.

Chart 2: US Consumer Spending and Labour Payments



Source: Minack

Consumer spending appears to have reached a ceiling and is unlikely to increase without a greater portion of business profits going to labour. With the US personal savings rate already relatively modest, wages will need to rise to support a further increase in US consumption.

Chart 3: US Personal Savings Rate

Source: Federal Reserve Bank of St Louis – Economic Research

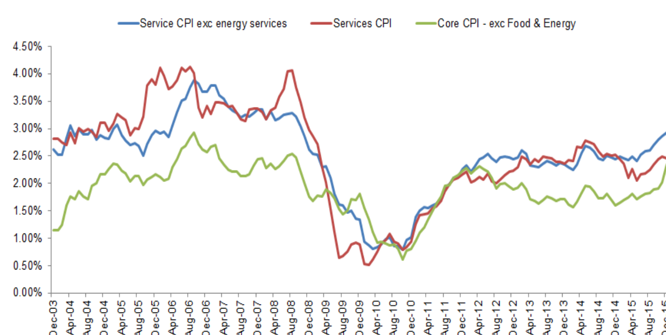
The housing sector in the US remains elevated, providing a continuing stimulus for the US economy. We recently met with some US housing companies. DR Horton stated that business is going well, with a good level of demand at the right price point. The Southern States are expanding rapidly (except for Houston) with Dallas at all-time highs. ACME Bricks suggested that they are up 17% in the first two months of 2016 (comprising 10% price and 7% volume). Their Commercial division (schools and hospitals) is also doing very well. Housing starts have bounced strongly since their 2010 trough. However, we expect that strong US housing starts could continue for another four-plus-year period given the extent of the under-build since the GFC.

Chart 4: US Housing Starts

Source: Federal Reserve Bank of St Louis – Economic Research

We continue to monitor services inflation (the items that impact household wages and quality of life, e.g. electricity, gas and telecommunications prices) for signs of inflation resilience. The signs continue to be positive, with price growth in the services CPI (ex-energy services), which represents 58% of the basket, now higher than any period over the past seven years (with the annualised six-month growth rate more than 3%). The Fed is already seeing an apparent acceleration in core price inflation; therefore, we believe it can't delay raising interest rates for much longer.

Chart 5: US Core & Services CPI – Jan 2016



Source: JCP Investment Partners

We continue to favour companies leveraged to the US economy, supported by our view that the underlying economy is moving in the right direction.

China

Debt-fuelled investment-led growth.

A recent research trip to China strengthened our view that the Chinese economy will continue to slow, with non-official data pointing to slower growth than official figures.

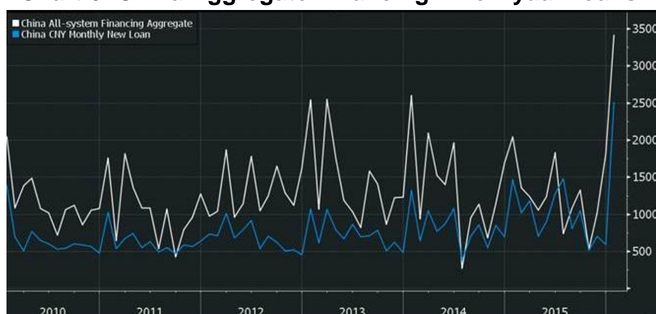
The Chinese Government has emphasised new supply measures to address overcapacity issues, which is positive, but critical constraints continue to hold back real reform, examples being unemployment levels and business foreclosures.

The recent Chinese National People's Congress continued to encourage the reform process, but the Communist Party's number one priority is still social stability. With labour market conditions expected to deteriorate, their resolve for genuine economic change will be tested in the future. The slow pace of capacity reduction in the steel and coal industries is a case in point. Actual cuts to production are difficult to identify. Likewise, we wait for a supply contraction in the western world (e.g. Atlas Iron in the seaborne iron ore market).

Accelerating credit growth (much more than nominal GDP growth) is funding China's investment-led growth. Although we expect this growth to continue to inflate the Chinese economy, it also brings with it the potential for future financial problems.

Recent growth in overall credit, using the PBOC's total social financing (TSF) measure, edged up for the first time since September (from 11.6% to 12.5% year-on-year), that is a US$525bn net increase in debt in the month of January. The reason for our concern about this rapid credit acceleration is that debt to GDP is already at 225%, and is growing at +25% of GDP per annum compared to a nominal GDP growth rate of only 4% to 5% per annum.

Chart 6: China Aggregate Financing – New yuan loans



Source: Bloomberg

Setting a target for the TSF growth rate of 13% this year demonstrates that China has not yet embarked on a pathway of deleveraging. Either their economy is exceptionally weak and unbalanced, or they are playing a financial trick on the rest of the world whereby ultimately unaffordable credit growth is used to purchase foreign assets and repay USD denominated debt, at an exchange rate that fails to reflect future devaluation risks or current real economic conditions. This pathway is only sustainable while they have the FX reserves to support their over-valued currency and because of quantitative easing in other key economies (Europe and Japan).

From an Australian perspective, the sheer volume of money created in China, compared to our relatively tiny asset base, highlights the risk of further capital inflows from China creating economic distortions that may support GDP growth in the short-term but create asset bubbles and associated financial risk for Australia in the medium term.

China's desire to slow the pace of selling its FX reserves was evident in the recent tightening controls on its capital outflows. These measures appear to be working with capital outflows easing in February. The value of China's FX reserves were US$3.2tn at the end of February, a decrease of $29bn from the month earlier, and implying net capital outflow of US$65bn (down from US$135bn in January).

Insights from our recent research trip to China were that the Chinese domestic economy will continue to rebalance, innovation will continue to emerge, and (subject to changes in supply arrangements) Chinese consumers will continue to demand sustenance products and recreation/educational services from Australian producers (particularly beef, milk, and vitamins). Baby formula pricing and volume exported through 'grey' channels are a bubble born from the 'four grandparent phenomenon' and the realistic concern that "China is poisoning us". However, there is a huge supply response coming down the path that will ultimately 'prick this bubble'.

Australian companies will struggle to make money in China other than selling volume at the border. As confirmed by our discussions with Austrade, many ASX200 companies have done extensive work and then decided not to invest in China, because the majority of the value is captured in the supply chain from the Chinese port to the customer.

Australian companies will only ever be able to sell goods as 'commodities' to this supply chain, with the price and distribution margins (including marketing and promotion) accruing to the domestic distribution part of the supply chain ex the port. The only way to generate a higher margin is to go directly to the consumer, which is challenging at this point. However, on a more positive note, there is a desire for foreign products perceived as safe, healthy and produced under proper standards, which translates to a genuine desire for many Australian goods, but success is dependent upon said recognition by the Chinese consumer.

From a portfolio perspective, we are more cautious on exposure to China, while recognising the upside risks to commodity prices from investment-led expansion stimulated by credit growth.

Australia

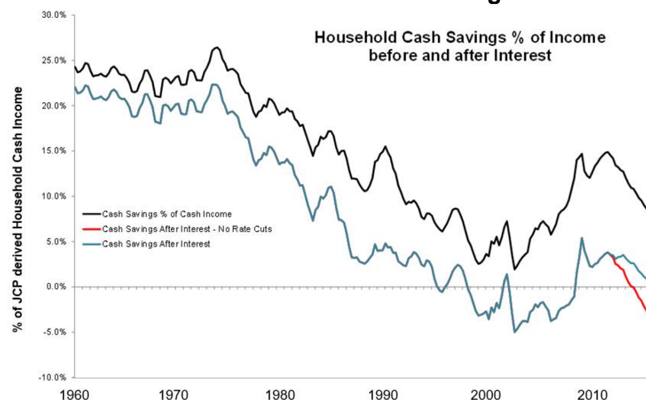
An Australian recession is a growing risk.

An Australian recession is an increasing risk due to: income weakness, business capital expenditure declines, and residential construction weakening from elevated levels.

We believe that leading indicators of employment, such as the NAB Business Survey and ANZ Job Vacancies Survey do not yet point to a recession for the reasons listed below.

The household savings rate has dropped to a seven-year low, with the saving rate continuing to fall below 8%. Although further falls in the savings rate are possible, JCP's calculation of Australia's household cash (excluding imputed rents and contributions to superannuation) savings as a percentage of income (after interest) is already close to 0% (see chart 7).

Chart 7: Household Cash Savings



Source: ABS, JCP Investment Partners

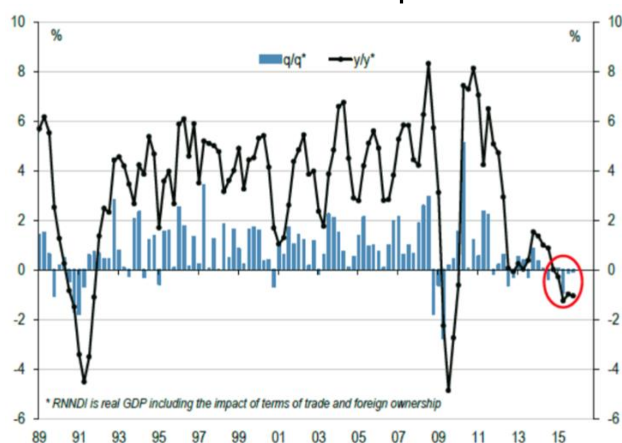
Employment growth has been stronger than expected because of job creation in sectors such as healthcare (which added 150k jobs last year). Despite these job gains, net employment growth in the overall economy has all but stalled in the last three months.

There has been elevated housing sector activity because of capital inflows, especially from China. However, with data suggesting capital outflows from China have slowed recently (as detailed in the China section above), as well as corroborating anecdotal evidence supporting this thesis, the housing sector may no longer provide the impetus to the Australian economy as we move forward.

Building approvals fell 7.5% month-on-month in January (-15.5% year-on-year), and housing finance approvals fell more than expected in January (-3.9% month-on-month), with broad-based weakness across key components and regions. Annual growth in approvals for investors (-16.0% year-on-year) is now at its weakest point since February 2009, highlighting that macro-prudential constraints continue to gain traction. Approvals for new non-housing construction have also fallen. The annual growth in house prices continues to decelerate, with data for March showing a +6.4% rise, a decline in the year-on-year growth rate which is the lowest since September 2013. In summary, it is increasingly clear that housing will not provide the impetus to GDP growth in 2016 that it has done over recent years.

Although the recent Q4 GDP headline figures did not point towards a looming recession (with a better than expected figure of +0.6% versus forecasts of +0.4%), the better than anticipated result was because inventories increased at an unsustainable pace. The important point is that real GDP is currently a misleading measure of how Australian domestic economy is faring. Our concern is the lack of income growth in the Australian economy. The issue here is the income drag from a falling terms of trade. Real national income fell 1.1% year-on-year and experienced the fourth consecutive quarter of year-on-year falls.

Chart 8: Real Net National Disposable Income*

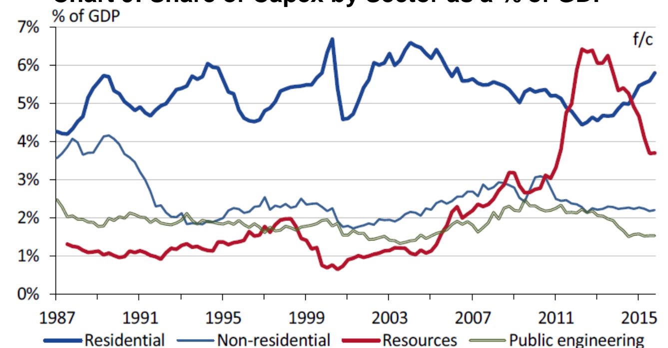


Source: ABS, UBS

Given this persistently weak national income, consumption growth is only being sustained by households drawing down on their savings, which is unsustainable. As such, we expect consumption growth to weaken from here.

With regards to capex, while the handover from the resources capex cycle to the residential construction boom is still underway, we expect this to fade going forward, given recent declines in building approvals, housing finances and the slowing growth in house prices as detailed above.

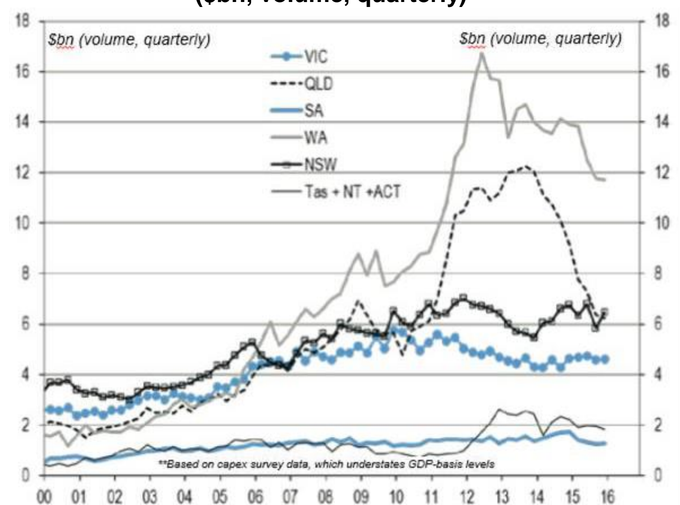
Chart 9: Share of Capex by Sector as a % of GDP



Source: ABS, Morgan Stanley

WA and QLD have experienced the bulk of the capex declines to date (see the chart below). However, the relative stability experienced in NSW and VIC thus far should start to unwind as the residential construction boom slows.

Chart 10: Share of Capex by State ($bn, volume, quarterly)



Source: ABS, UBS

The external and structural risks for the domestic economy are very high. There are enormous financial risks posed to the Australian economy from an oversized banking sector, which is now starting to display the first signs of stress. It is clear that the credit cycle has now turned, albeit at the margin. Recent updates from the major banks have highlighted that bad debts are starting to rise after several years of falling.

Also, bank margins are under pressure given signs of increased competition in the major lending segments.

Without other drivers for sustained productivity growth at hand, and a small likelihood of massive government infrastructure stimulus in 2016/17, we see domestic conditions becoming increasingly challenging. In such an environment the risk of bad debts and higher unemployment are positively skewed, which is likely to place further pressure on the Australian banking sector.

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.

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. **A continued improvement in the US economy**

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

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

Conclusion

The portfolio has delivered strong outperformance over the past year and the recent reporting season has further strengthened our view in regards to portfolio positioning. As such, we expect this outperformance to continue given we are in the early phases on this current performance cycle. The portfolio continues to be 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 driven by panic and fear on the one hand and unsustainable expectations and structural headwinds on the other hand.

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