

# Market Commentary: April 2013

## EXECUTIVE SUMMARY

- A continuing abundance of liquidity from developed world central banks is proving highly supportive of growth, asset prices (including equities and property) and keeping downward pressure on yields.
- While softness in recent global leading indicators suggests there may be some short term volatility over the next quarter or so, our base case is for acceleration in global growth in both 2013 and 2014, a net positive for corporate earnings trends and equities.
- While our call in our previous Market Commentary for an improving performance from Resources proved premature, compelling valuations, after recent sharp falls, now make us even more confident that a modest overweighting to resources is warranted.
- The biggest risk to markets is the transition phase when central banks withdraw quantitative easing, and interest rates start to normalize from emergency levels. Rising interest rates could potentially create a period of high volatility in bond, equities and currency markets. This is more likely to be a 2014 event, however we intend to maintain defensive portfolio structures ahead of this.

## Full Year Target of 5,000 Delivered in 6 weeks!

Following on the very strong market gains in second half 2012, we have been surprised by the continued strength during Q1 2013. The ASX200 index has recorded yet another impressive gain of 6.8% for the quarter, making it 14.6% for the last 12 months. If dividends are included, the gain for the quarter was 8.1%, and for the 12 months, 20%. Industrials (including Financials) put on 10.6% as Resources lost 7.5%.

## Investment Themes in Tact but Timing Questionable

Reviewing our key strategic positions from last quarter, 'income **yield**' focus has remained a key driver through the first quarter. Aggressive Japanese quantitative easing has added to the diminished likelihood of further rate cuts in Australia.

### Industrials Outperform Resources



Source: Bloomberg

Our call on **Resources and Commodities** has proved premature. Our longer term concerns on iron ore, thermal coal and LNG have been discounted into resource stock valuations during the recent quarter. Based on short to medium term commodity prices, stocks now look cheap.

Of the remaining two themes, '**Overseas Earners**' continue to perform well and remain attractive. **Industrials** continue to look vulnerable from an earnings point of view, although we have seen an improvement in activity in sectors such as housing, discretionary retail and financial services

## Key Themes from the Credit Suisse Asia Conference

Peak was again able to attend the Credit Suisse annual Asia Investment Conference in Hong Kong in late March. Some 260 companies from across the region participated. Over 1,000 investors from around the globe attended and included keynote addresses by the likes of Jean-Claude (former President of the ECB), Laurence Fink (CEO of Blackrock, one of the worlds largest fund management groups) and Jack Ma (CEO of Alibaba, a major online trading business in China). Some of the **key economic themes** to emerge from the conference included:

- Global growth expected to accelerate in 2013 for the first time in almost 3 years, driven by a stabilisation in developed economies and stronger developing economies.
- Financial markets are awash with central bank "excess liquidity". The short term stability accorded by these policies may have unpredictable longer term outcomes.
- Views are generally positive on the US recovery (though headline numbers depressed by fiscal tightening). More positive on Japan under new political and BOJ leadership. Eurozone two thirds the way through a major adjustment phase. A diversity of views on China (though consensus on GDP being maintained around at 7.5% to 8%).

- Notwithstanding some weakness in short term forward indicators, equity markets generally look well supported by easy liquidity conditions that appear set to prevail into the medium term. High unemployment, subdued rates of growth, excess capacity, minimal inflation suggest there will be no short to medium term pressure on central banks to change tack.

#### **Key Investment themes to emerge included:**

- Emerging market consumption exposure remains very attractive. From China to Indonesia, growth in incomes is taking substantial numbers of people into the "middle class". China's consumption as a % of GDP is 32%, the US is more than 70%. We hold AMP China Growth Trust.
- An aging population with increased longevity is creating a range of changes. Pension funds need longer duration (ie less bonds, more growth assets with income), longer workforce participation, need for government sector "re-calibration" on defined benefit plans. Franked income investments will remain compelling.
- Bonds have been in a 30-year "bull market". Over the medium term, Equities are expected to do better than Bonds. The current low yield interest rate environment is not sustainable. Avoid Bond investments.
- Some of the specific sector themes to emerge from the conference included Industrial automation, global travel, reduced carbon emissions, digital and social media, online retailing and the aging demographic.

As portfolio managers, we attempt to incorporate these themes into our stock selection process with the objective of delivering long term superior performance.

#### **The Resources Conundrum**

We have been both wrong and surprised at the veracity of weakness in the resources sector over the last month particularly. With most professional forecasters pointing to a weak second quarter 2013 to be followed by a stronger second half, accelerating global growth is normally positive for commodities. Perhaps the weakness is just a reflection of what has become a very short term focused market.

As our major driver of both corporate earnings and exports, iron ore is key. We have long expressed the view that high prices were not sustainable given the 'supply side' response. It now seems to us that the market has caught up and swung the pendulum too far the other way. By discounting iron ore prices of \$90 per tonne (v. current spot price of \$139) into stock valuations, it seems to us that the risk and share price opportunities have now moved to the upside. These variables can change very quickly!

The market has also chosen to completely ignore the major shift in the corporate strategy of mining companies. Under new management, the 'go for growth' has been replaced with 'responsible capital management'. As Commsec recently highlighted, RIO is Australia's biggest tax payer, generating the most franking credits. Post 2015, they should have substantial capacity to pass the benefits through to shareholders. BHP is now yielding 5% including franking. Given the underperformance, the valuation matrix, and the ownership structure, it is hard to see this underperformance as justified.

#### **Portfolio Strategy**

Portfolios with a structure balanced between financials, industrials and resources have delivered strong results. Since June 2012, markets have been favourable. Such conditions don't last forever. While being positive on equities on a medium term view, we intend to maintain defensive portfolio structures shorter term. This reflects the fact that we are not in normal times.

There is an upcoming transition period where central banks will stop/slow the massive liquidity injections of recent years. Historically equities react well to the initial increase in rates to reflect an upturn in growth. The level at which equities start to react negatively will remain a much discussed subject. This transition period presents both risk and opportunities. Our objective is to be prepared for our clients!

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