Market Commentary: January 2013

EXECUTIVE SUMMARY

- Our expectation is for the ASX200 index to move beyond the 5,000 level in 2013, delivering investors a 10% total return including dividends, before the benefits of franking credits. This follows a 20.5% total return in 2012.
- Following two consecutive yearly declines in commodity prices, we anticipate 2013 will be a better one as global growth shows modest expansion. Resources are likely to do better than Industrials.
- High yielding equities are expected to hold up, though are unlikely to repeat the stellar returns of 2012. “Overseas earners” are expected to have another good year.
- Following the recent rally, we see the market as vulnerable in the short term. The search for yield has led to a re-rating of equities. In the absence of any material improvement in corporate earnings, many defensive Industrials look fully valued.

Systemic Risk Down, Growth Up, Macro Problems Remain

As we enter the Chinese Year of the Snake, 2013 is appearing like it might be the first year since 2007 that the world is not facing some imminent financial disaster. This does not mean there is nothing to worry about, there clearly is. But it does appear that the vast amount of cheap liquidity has stabilised the global banking system, reducing the risk of systemic failure (including Europe). Economic activity appears to be expanding marginally in the US and Japan, and has stabilised in the Eurozone. Following two consecutive years of declining growth in the BRIC’s (Brazil, Russia, India, China), 2013 is expected to see acceleration in growth. According to Bloomberg, global GDP growth will increase marginally from 2.2% in 2012 to 2.4% in 2013, driven entirely by the emerging economies.

Australia Outperforms Global Equities, Industrials Outperform Resources

This more stable outlook for 2013 provided the foundations for a good year from equity markets during 2012, particularly during the second half. Global equities are up 14.4% (MSCI World Total Return) for the calendar year, with Australia recording a very solid 20.3% gain. Much of this gain has been led by defensive stocks offering high yields, with some solid support from the Resources sector in the final quarter. In contrast, the ASX 200 Industrials delivered a total return of 28%, the ASX200 Resources just 1.3%.

For Australia in 2013, we are inclined to think that it will mirror the developed world with growth slowing, rather than tracking emerging economies as we have tended to since 2008. As the impact of the resources investment boom moderates in 2013 and beyond, there needs to be a material recovery in the non-mining part of the economy. We are not yet convinced that this will happen. The RBA has been cutting interest rates since October 2011, and to date, the non-mining sector remains subdued.

Will Interest Rate Cuts Finally Impact?

The absence of a traditional response to a 1.75% reduction in cash rates over a 15 month period appears to have its genesis in a number of factors, most of which seem likely to persist into 2013. They include:

- Despite the official CPI figure remaining stable, costs of essential services are rising faster than incomes
- While many households are attempting to deleverage, costs rising faster than incomes are producing the opposite outcome
- While the official unemployment rate has remaining surprisingly stable, job security appears to be a material issue, particularly when corporate earnings growth is being driven by cost reduction programs
- Concern over the sustainability of house prices

Challenges in Growing Corporate Earnings

Cost reduction programs have become a key focal point for corporate earnings growth. For banks, with credit growth at multi decade lows, top line revenue growth is very hard to achieve. We don't see this changing materially in 2013, or certainly not in the first half. There is little evidence of personal deleveraging coming to an end. Banks are relying on cost reductions and margin management (ie not passing through the full effect of interest rate cuts to customers) to boost bottom line earnings. Similarly in Resources, the volatility in commodity prices has led to resource and resource related companies shifting focus to reducing cost structures as a way of boosting / maintaining earnings

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Yield Focus to Remain…

The stunning performance by the defensive, high yielding part of the market is unlikely to be replicated in 2013, although returns are still expected to be well ahead of cash and term deposit rates. With a strong possibility of further interest rates cuts in the first half of 2013, we expect to see further flows out of term deposits into higher yielding equities.

…Resources to Have a Better Year

In contrast to 2012, we expect the Resources sector to have a better year in 2013. Through much of 2012, the non-Asia consensus view was for a hard landing in China. This appears to have turned late in 2012, following a series of policy easing measures supported by the leadership change in November. Stimulus to a range of infrastructure projects including high speed rail, power transmission and public sector housing has produced a remarkable recovery in iron ore prices from September lows of $86 per tonne to $158.50 recently. While we don't see current levels as sustainable, prospects of accelerating growth in 2013 should support commodity prices in 2013. Our expectation is that Resource majors BHP and RIO will have a better year in 2013, along with Newcrest.

Commodities: Short Term OK, Longer Term Risks

Longer term, we remain cautious to bearish, particularly on iron ore, LNG, and thermal coal. In these commodities, the much awaited supply side response is now on the horizon, putting significant risks into long term price outcomes. This is not something to be particularly concerned about in the first half of 2013, however it is one the longer term themes we have under close observation. For thermal coal and LNG, the implications of increased oil production in the US and cheap gas from shale deposits seem destined to deliver profound changes on global energy markets over the medium and longer run. Holdings in Woodside and Santos are under review, having largely exited Origin and AGL.

"Overseas Earners" Expected to Outperform

Another group of stocks performing exceptionally well during 2012 that we envisage doing so again in 2013, are the group of "overseas earners". While this group does contain a number of world-class companies such as CSL, Cochlear, News Corp, BHP, RIO, Brambles and Worley Parsons, their investment returns during generally 2012 were above average. These were achieved with no assistance at all from the $A. With global growth expected to modestly accelerate in 2013, this group should have another good year in 2013.

Share Prices Run Ahead of Earnings: Industrials Vulnerable

We make the observation that the strong performance by Industrials during 2012 has been primarily "liquidity" driven. Investment dollars have been taken out of cash and term deposits into higher yielding stocks. So while Industrial shares have provided a total return of 28%, EPS growth has been single digit at best, and is currently expected to remain so in 2013 and 2014. High yielding Industrials have been re-rated upwards, and are now fully valued on fundamentals. The current Industrial sector valuations are vulnerable to any deterioration in earnings growth prospects.

Our commitment remains to deliver investment solutions to our clients together with a strong relationship. We are always very appreciative of referrals from existing clients and our professional network.
We wish you and your family a happy and healthy 2013.

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