Market Commentary: January 2014

Global Economic Overview

As we enter 2014, it is now more than 5 years since the depths of the Global Financial Crisis (GFC). Back in 2009, we did talk about the likehood of an extended “workout period” that would be required to restore the financial system to a more normal state. The early economic signs (after 2 years of strong market gains) are that 2014 may be the first year since the GFC that there will be some semblance of stability and predictability about the health of the global financial system. We base this assertion on the following points:

- Synchronised growth appears set to return to the major developed world economies in 2014, including the Eurozone and Japan
- The incumbent leadership team in China appear to have stabilised growth at 7.5%, while embarking on an aggressive reform program
- Leading indicators such as PMI (Purchasing Managers Indices) have been strengthening across the developed world – a good positive forward indicator for stockmarkets
- In the US there are signs that banks are again advancing credit, and in Europe lending rates have fallen significantly. Instead of hoarding zero cost funds, banks may start to conduct normal business again
- The Federal Reserve and the European Central Bank (ECB) have started to wind back their stimulation programs (ie Quantitative Easing). The ECB has reduced its balance sheet by 25% since mid 2012, though in doing so, deflation remains a major risk
- Quantitative Easing does now appear to be flowing into the “real economy” via asset price inflation, increased credit growth, improving business and consumer confidence readings and better labour markets

While these trends all look encouraging, a number of key variables remain a long way away from normality. Key factors include:

- Cash rates in most of the developed world anchored at 0% at a time when bond yields are rising, reflecting stronger growth prospects
- Price and wage inflation continues to remain subdued, regardless of the massive quantitative easing programs underway
- The developed world is now awash with excess savings. Governments are cutting spending, the private individuals are reducing debt, companies are not investing, making acquisitions, instead increasing dividends and buying back stock

Implications for Equities

2013 was a very good year for global equity markets, with the US S&P 500 up 26% in US$ (+47% in A$), Europe up 17% in Euro (+39% in AS$) and Japan 49% in Yen (+51% in A$). Emerging Markets have generally underperformed. (Source: Bloomberg)

Interestingly after such strong gains, while emotion would suggest they cannot be repeated, history infers that more often than not, the following year is another up year with double digit gains .

Our own sense is that 2014 looks like another constructive year for equities. We base this assertion on:

- A scenario of synchronised global growth where corporate earnings seem likely to accelerate again
- Profits and margins seem protected by continuing low interest rates, minimal evidence of wage pressures and continuing technology-based productivity gains
- The outlook for commodity prices looks benign, including oil
- Diminished emphasis by investors on “capital safety” and a marginal re-weighting to “risk assets” ie shift from bonds to equities
- The associated flow of funds may lead to further multiple expansion in equities, notwithstanding we are already at the upper end of fair value in most markets
- “Tapering” by the Fed and ECB is now underway, and largely discounted into equity valuations.
- The bigger issue for equity markets will come from when it is perceived that future cash rates start their inevitable upward climb. This does not look likely during the first half of 2014

Australia at Inflexion Point

Having successfully traversed the GFC, courtesy of a close tie to China via commodities, Australia is now poised to see that nexus weaken. Lower commodity prices (partially offset by higher volumes) and a significant decline in the mining and energy investment boom are now set to see growth come from more domestic/conventional sources.

The big issue for investors is how smooth that transition is. Technically it comes down to the relative rate of change between the slowdown in resources investment and the recovery in the predominantly East coast economy.

Recent trends in housing construction activity, property prices, consumer and business confidence along with retail sales trends through Christmas / New Year do appear encouraging. The “wealth effect” culminating from rising property prices and positive superannuation fund returns should also assist. It is also clear that the 18% devaluation in the $A is helping company earnings and businesses generally.

Market Prospects for 2014

Following two consecutive years of declines in corporate earnings, 2014 and 2015 appear set to produce solid gains. This is after the market has provided compounded returns of 20% p.a. for the last 2 years.

2014 will be driven by higher resource company earnings where volume growth and a lower $A will be supportive. Thereafter will be more about a general cyclical upturn in Australian Industrial companies.

Equity valuations are elevated at 15x 2014 & 13.8x 2015 earnings growing at 11.5% in 2014 and 9% in 2015, (Source: Goldman Sachs) but may well move higher under the current set of circumstances that include:

- Accelerating earnings growth momentum through 2014
- Continuing asset allocation shift out of low yielding assets to more risky ones
- Improving levels of domestic and overseas confidence in the post Gillard/Rudd era, helped by A$ decline

Based on our “bottom up” work, we can see the ASX200 Index reaching 6,000 by the end of 2014. This would provide investors with another pretty good year (the third in a row), though still leave us some 20% short of 2007 levels (but we are 3% above 2007 high on accumulation index). A 12% capital gain and a 4% dividend yield supported by an additional 1.5% in franking benefits will result in us maintaining relatively high levels of investment.

Key Investment Themes for 2014

1. Given the superior growth prospects of the US compared to Australia and the possibility of further $A depreciation, we continue to be overweight companies with a significant proportion of earnings coming from outside Australia (Brambles, 20th First Century Fox, CSL, Amcor, Crown, James Hardie)
2. On the basis of increasingly favourable demographics, technological developments and discretionary lifestyle choices, stay overweight the Healthcare sector, particularly Ramsay and CSL
3. Stay market weight (27%) the major banks. While valuations do appear relatively expensive, we see the combination of improving trends in credit growth, further efficiency gains via technology and other cost reductions providing modest earnings growth. This, combined with very strong capital positions, is likely to lead to further distributions to shareholders initiatives.
4. Maintain exposure to companies that are exposed to the equities market cycle. Our view is that there will continue to be a positive trend for equity markets during 2014, IPO new issuance activity will remain at elevated levels and superannuation remains a growth industry in Australia. Key stocks include Perpetual, Magellan, ASX and selectively Macquarie Group.
5. For more defensive portfolios seeking greater capital stability and sustainable income, in the infrastructure and REIT space we prefer Transurban, APA and Stockland, along with recent smaller IPO’s - Australian Industrial and Hotel Property Investments.
6. Maintain a market weight (15%) position on Resource heavyweights BHP, RIO and Santos. While we do not see a lot of excitement for commodity prices, we do expect earnings will remain supported by solid volume growth, a lower $A, reduced levels of gearing and “cost out” programs.
7. Stay overweight companies with successful and sustainable “online business models”. This includes Seek, Carsales and REA Group (once the management vacuum is resolved). Select ‘online’ overseas stocks may also be added.
8. We are attracted by the thematic of increased demand for protein from the developing world including stocks such as Graincorp, Bega, Synlait, A2 (latter two are NZ stocks);
9. With the prospect of some ‘cyclical’ recovery in Australia during 2014, we have structured most portfolios to have some exposure, to likes of Wesfarmers (Bunnings, Kmart, Target), Adelaide Brighton (Building Materials) and Stockland (Housing).
10. Avoid companies and sectors with secular and structural challenges and impairments such as airlines, traditional retailers, print media, free to air television, retail REIT’s, steel, mining services and most insurance companies.

We look forward to catching up with you soon to discuss your portfolio and address any change of circumstances or issues that we might be able to help you with.

Ian Wenham	**Richard Nicholas**	**Andrew Martin**
Director	**Director**	**Director**