Welcome to the September 2013 edition of the Martin Bros Monitior.

In this edition of the Martin Bros Monitor:

Seasonal Headwinds = Opportunity

Reporting season has come and gone with the passing of August and the general theme was subdued top line growth (revenue) with slightly improved bottom line growth (net profit after tax or NPAT). As a general rule this resulted in a modest uptick in dividends across the board. CBA reported a record dividend but the three other major banks do not report their full year results until November.

Since our last MBM the market has recovered once again to be just under 5,200. Anytime we have seen a sell off in the past twelve months we have seen a lot of buying come in to snap up the better value on offer. We have certainly entered the phase of “buy the dips” rather than “sell the rallies” that dominated the last four years. As a very general guide, these phases / cycles typically last 3-5 years.

We have spoken for some time about the bond bubble bursting. This finally commenced in May when the US 10 year bond yield bottomed at 1.60% and climbed to 2.05% at the time of writing the June MBM. Fast forward to today and the US 10 Year Bond yield is at 2.86%. In rough terms this equates to about an 8% capital loss (bonds are priced inversely to their yield so when yields (interest rates) rise, this results in a capital loss). So this means that if you bought a US 10 Year Bond in May at 1.6%, it will take you 5 years of interest payments (1.6% x 5 years = 8%) to break even. Not quite as "fixed interest" as they sound!

This jump in yields has been triggered by speculation that the Federal Reserve in the US will shortly begin to take the foot off the accelerator on their Quantitative Easing (QE). The first step in this process is to reduce the $80B (yes Billion) per month of long bond (10 years) purchases that the Federal Reserve are currently making. Although they have not started this process yet, the market has already reacted in expectation of this change. This means that people have been selling bonds, knowing that there will shortly be less demand for them and prices will fall (yields will go up).

Despite the already savage move in bonds, the exodus from this asset class has only just begun. Future moves in yields may not be as severe, in such a short space of time, but the writing is on the wall for US 10 Year Bond yields to be back at a 4% within the next year or two (as a rough rule of thumb, 10 year bond yields should equal GDP & CPI). The US 10 Year Bond yields are not alone, as global bond rates in many countries have also had similar moves. In Australia, our 10 Year Bond yield has risen from a low of 2.7% to just over 4.0% today. As money moves out of this asset class over the next 1-2 years, a portion of this will be re-invested into equities.

In addition to this, in Australia there is a record $600B in term deposits, much of it with less than one year duration. As this money matures and investors are offered new rates of 3.5% for their money, some of this will flow into equities where gross dividend yields are 1.5x-2.0x this level. Then, on the back of further equity market gains, people will once again be chasing capital growth in earnest as the lazy money realizes you actually do make money out of shares in the long term. Unfortunately for a lot of these people they will be joining the party when it has already been going for two years.

As we mentioned earlier, our equity market has recovered to just under the 5,200 point level. There are a few reasons why we think there may be another short sell off (circa 5-10%) in the next few months. These include potential Allied strikes on Syria, US fiscal cliff approaching (again), German elections and market unrest in Asia (note recent dramatic moves in Indian, Thai, Philippine and Indonesia equity markets and currencies). Our equity market also outperformed the US markets in August by the greatest amount in over four years. This historically results in us underperforming in the following month.

Combine all of these factors and overlay them onto the September to November seasonal period which is historically (over many decades) the weakest on global equity markets, and you have the recipe for a short term pull back. Our recent outperformance can be attributed to a decent reporting season and the upcoming one horse race (election). Our market has been rallying on the back of the election outcome, given the Coalition is a $1.03 favourite to win, rather than waiting for the actual result.

Any pull back, if it is to occur, will be viewed as an opportunity to add to positions or re-balance portfolios where appropriate. In the long term, any pull back will be irrelevant, although it may not feel like it at the time. There will be a Christmas / summer rally again, and our guestimate of the market in six months time is 5,500 points. It may just be a little bumpy in the short term, but there are plenty of reasons to be optimistic in the years ahead.

Stock Review - Incitec Pivot Limited (IPL)

Incitec Pivot manufactures and distributes a range of industrial explosives, fertilizers and related products around the world. It operates in three principal countries being, Australia, USA, and Canada. It's products are at the centre of long term global growth trends in resource consumption (explosives) and food production (fertilizers).

Incitec Pivot made a company transforming acquisition in 2008, purchasing Dyno Nobel to gain a foothold in the lucrative industrial explosives market to compete with the likes of Orica. At the time, Dyno Nobel was in the process of undertaking to build a new ammonia nitrate (raw ingredient of explosives) plant in Moranbah, Queensland. This plant (pictured above) has now been completed and is in operation, which will significantly increase IPL's revenues and free cash flows from explosives. In addition, IPL has recently approved the development of a new plant in Louisiana which will be able to produce lower priced finished products for the large and lucrative North American resource and construction industries.

IPL is trading, on our analyst's forecasts, at a price to earnings ratio of just 10x and 5.27% dividend yield for FY2014. This is below global peers and more reflective of an industrial company with low to nil growth prospects, rather than the growth profile that Incitec Pivot enjoys. Our analyst has an outperform recommendation and a twelve month price target of $3.36 (currently $2.62).

Please join us in (belatedly) congratulating Martin Bros team member John Cleary on the safe arrival of his first child, a baby boy named Harry, back in April.

Mum, Dad and Harry are all doing well, having just returned from their first family holiday to Queensland last week.
