Martin Bros

MONITOR

Creating Long Term Financial Success For Our Clients

Welcome to the September 2015 Edition of the Martin Bros Monitor.

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Seasonal Jitters

As long time readers of Martin Bros Monitors (MBM's) will know, we are now in a seasonally weak period for global equities (Sept / October). This is again holding true as the bull market of recent years, fuelled by easy access to cheap money from Quantitative Easing (QE) programs and low interest rates around the world, experiences a correction.

In Australia, this correction has been a little deeper than in the US and Europe (but not China!), with our equity market down 12% from its mid July peak, versus the US down 8.1% and Europe down approximately 10%. As with all corrections they tend feel worse than perhaps they are when you are in the eye of the storm.

Let's look at the three main factors driving the recent sell off in Australia. Two are global issues and one is of a domestic nature.

The first is the pending increase in official US interest rates. This will be the first increase in official interest rates since pre the GFC (more than seven years ago now). All risk assets globally have had a boost in the last few years from low interest rates and QE programs which seek to encourage investment to stimulate economic activity. This appears to have worked in the US where they now have the best growth rate of any developed nation.

As economic and jobs growth continues to improve in the US, the cheap and easy money “tap” is slowly being turned off by the Federal Reserve. This began with the gradual winding down of the QE program over a 12-18 month period, beginning in 2012. This process was knows as tapering down the QE program. The next stage of this “normalization” process is beginning to raise official interest rates from the historical low level of 0% in gradual increments.

Prior to the commencement of QE tapering in 2012, the US market (and the rest of the world followed suit) sold off circa 15%. This was colloquially referred to as “Taper Tantrum”. Markets recovered over the next few months and continued to rise during the tapering process.

The US will raise official interest rates, as has been well flagged, at the Federal Reserve meetings in September, October or December. If they lift off with the first rate rise in September, then equity markets may rally sooner rather than later. The federal Reserve is going to raise rates, so in our opinion they should tear the band aid off now and give the markets what they want – certainty - rather than the unknown of will they / won’t they. The Federal Reserve should have learnt from the Taper Tantrum and this recent sell off in equities might just spur them on to act sooner rather than later.

When official interest rates do begin to rise, the increases will be small and gradual. Monetary policy will still be ultra accommodative. This is one of the reasons we feel the yield trade is not over just yet. In addition, rising interest rates will only be occurring because the US economy is doing well. A strong US economy is also helping to drive the US higher, which helps Australian investors with overseas shareholdings or exposure to companies with US earnings.

The second factor contributing to the recent sell off is the slowing Chinese economy and sharemarket crash. The Chinese sharemarket effectively doubled over the past eighteen months, fuelled by rampant speculation and growth in margin lending (sound familiar – GFC!). This has now largely unwound and Chinese equities look reasonably valued again. The Chinese economy is undergoing a large change from production / construction led growth during the 2000’s to a consumer / services led growth policy. This is a deliberate plan on their behalf and has long term implications for Australia as we have witnessed over the past couple of years with the unwinding of the resources boom.

These cycles tend to be quite long in duration. Rio Tinto is the only large company sticking with their bullish forecasts for Chinese steel output (iron ore). BHP has revised their forecast for peak steel production to be 25% lower than previously thought.

The Chinese economy is slowing and perhaps faster than previously thought. This can be expected as the economy transitions to a consumer / services led economy. Growth rates we have seen in the past decade as a manufacturing and construction led economy cannot be sustained as the economy morphs into a more western style economy. China will continue to grow strongly by western world standards, but the drivers are different and this will continue to affect Australia.

This leads nicely into the third and final major factor contributing to the recent equity market sell off. That is the

domestic economy and its outlook. In August, several of Australia's large banks announced capital raisings to lift their tier one capital (as required to meet future capital requirements under the Basel inquiry). This inevitably created some selling. Further, ANZ announced the bad debt cycle low had peaked, meaning bad debts will begin to slowly tick up (which is a normal part of cycles).

Commodity prices have continued to fall as the US dollar strengthens. This has resulted in reduced profit expectations (again) for may of Australia's large companies and also means our National income is falling further and faster than predicted by the government (they should pay more attention to what has been occurring on the share market over the past couple of years). This means growth is coming off quicker than expected and it is yet unknown how quickly other sectors such as tourism, housing construction and education will be able to pick up the GDP hole left by falling commodity prices and resource investment.

All of this has led hedge funds to sell first and digest later. The first two global factors discussed above have also made their selling decision easier. As the US economy improves and they begin to raise interest rates, their dollar will continue to be well supported. Several economists are now predicting the $A/$US to be in the mid 60 cent range next year and possibly lower. This significantly lower $A is and will continue to boost several important sectors in the Australian economy.

The themes we have been talking about for some time now are not over in our view. That is, falling commodity prices, falling $A and low global cash rates (not necessarily long bond yields). We continue to be positioned for this.

We finished our market update piece in the June Edition of MBM with the following quote. It still rings true today we believe:

"The yield trade is still alive. Buckle up for more volatility, as we warned last year. But this is nothing to be afraid of. If anything, it will create some opportunities along the way."

Wesfarmers Limited

We recently heard from the CEO of Wesfarmers, Richard Goyder, and it is fair to say that we were as equally impressed by their story as we have ever been. Management are not resting on their laurels despite the core retail businesses performing very well, particularly in light of the broader retail market, and their focus of return on capital employed is as strong as ever.

Some Key points from the presentation (by Morgans analyst Mark Williams):

Strategy

- Focus remains on Return on Invested Capital (ROIC), driving good cash generation
- Balance sheet is in good shape, appropriately geared with A- credit rating

- Key CEO focus is on developing human capital in the business
- With the competitive environment, there is heightened awareness over becoming complacent

Coles

- Business has good momentum, important in the Supermarkets business. 2 out of 3 of stores have been refurbished with the remaining third to be done over the next 2-3 years.
- Good to hear the focus is on growing EBIT (Earnings Before Income Tax), rather than on margins as it can lead to deteriorating customer service (something Woolworths has experienced). Focus is on generating higher sales and therefore higher EBIT.

Bunnings

- Strong store rollout program will continue with 10-14 new stores per annum.
- Business has been benefiting from significant tailwinds from the housing market, particularly in Sydney and NSW broadly. Doesn't expect the business to maintain 10%pa growth for the next 5 years, but expects "above system growth" depending on the housing market.

Target

- Focus is on women's apparel, homewares, and children. A lot of work has been done on improving the product range and improving sourcing of products.
- Management has worked hard to move the business to a "first price, right price" model, as opposed to the "high-low" strategy previously. Making traction with customers now.

Wesfarmers (WES)

Market Cap:	A$44.7bn	FY16 PE:	17.4x	ADD
Share price:	A$39.75	FY16 EV/EBITDA:	9.7x	HOLD
Price Target:	A$44.62	FY16 Yield:	5.3%	REDUCE

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