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

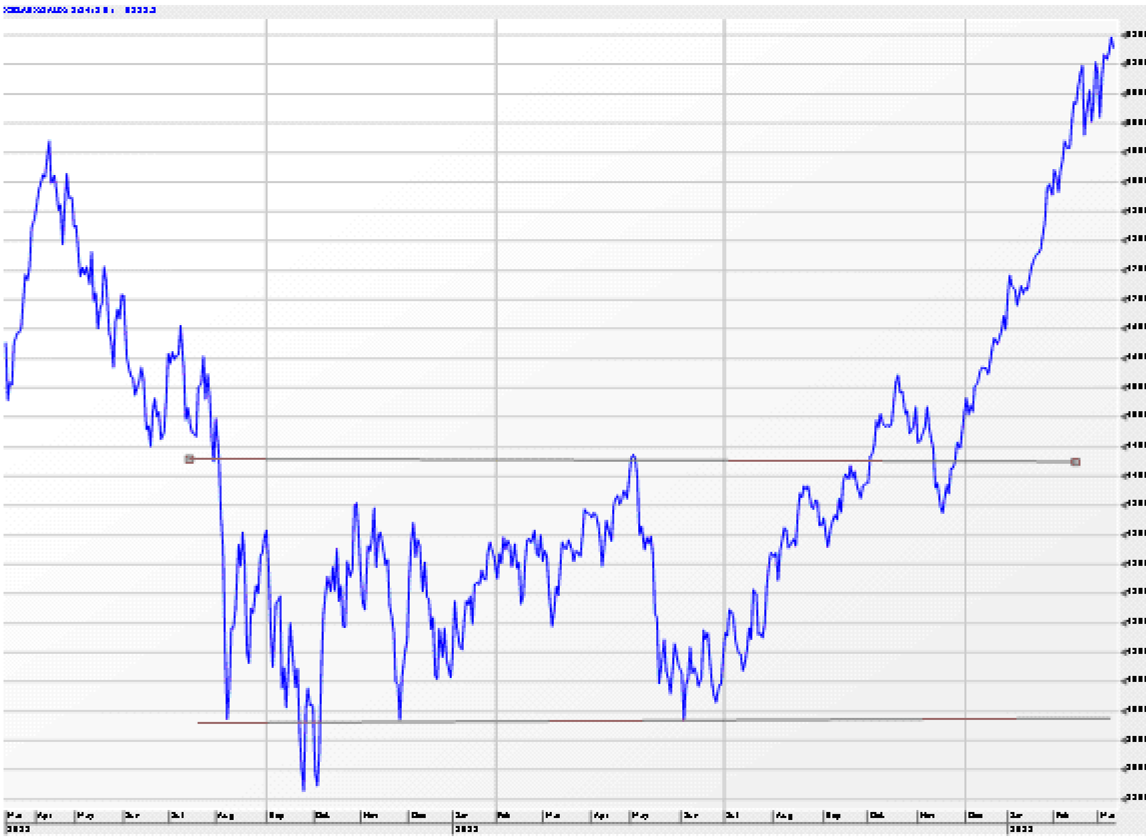
In this edition of the Martin Bros Monitor:

A CHINA CRASH - The Last Great Hope of the BEARS

It has been a remarkable run in global and local equities since our last quarterly Martin Bros Monitor (MBM). The buyers certainly have returned to Australian equities as we anticipated in our December edition of MBM. This renewed demand has also been met with the opposite phenomenon ("sellers strike") to that we wrote about last quarter ("buyers strike"). As people have continued to chase "yield" (income), this buying has been met with very little on the offer (sellers). As a result we have had a "melt up" in domestic equities over the past three months (except for China facing equities which we will get to).

Of course, the rate of increase in many share prices cannot continue at the same breakneck speed. There will be times ahead where the month on month performance of domestic equities is negative. However, we feel these will be few, and far less extreme than **everyone** has become used to over the past two years.

We are not psychologists but we can claim to have some insight into investor psychology. As investors, humans are heavily influenced by their most recent experiences. By recent we mean 1-2 years. Over the past couple of years, every time the market went up 10%, it was invariably sold back down – refer to below chart of the ASX200 over the past two years. This meant we were stuck in a trading range and some degree of shorter term activity was warranted to try and take advantage of this volatility.



However, since we broke through the top end of this trading band, the risk has been to sell into the rally. For two years investors were conditioned to “sell the rallies”. Now, within three months, this strategy has been completely blown out of the water. Many investors, including professionals (i.e. Fund managers) have been caught short / underweight as they were hoarding cash and waiting to buy back in on the dips. But instead of the dips being 8-10%, we have seen these limited to just 2% since the rally began in late 2012. Hence, there remains a wall of buying, hoping and praying we will see a 10% sell off so they can get set.

Each percentage rise we get, the calls get louder for an imminent correction. This is from the hopeful “Bears”, who whilst they were busy hibernating for the winter, began to convince themselves that the winter was turning into to the next big freeze. However, things turned out **not** to be different this time and the seasons have rolled on, winter became autumn and markets broke out of their slumber. Everything goes in cycles, and this time is no different.

Whilst we admit the recovery over the past few months has been unsustainable in its trajectory, we do not believe it means we have to have a correction (technically a correction is a 10% fall). In fact, we do not believe we will see anything larger than a 5% pullback in the short term, as there is a wall of buying just waiting and praying for a pullback so they can add to their underweight or non existent equities exposure. There has been and continues to be a “sellers strike”. Even though prices have jumped, if people were to sell, where would they put the money? Into a term deposit yielding 4% and falling? Not likely. The yield support on shares is still far superior to term deposits, and dividends are growing and term deposit yields are continuing to fall.

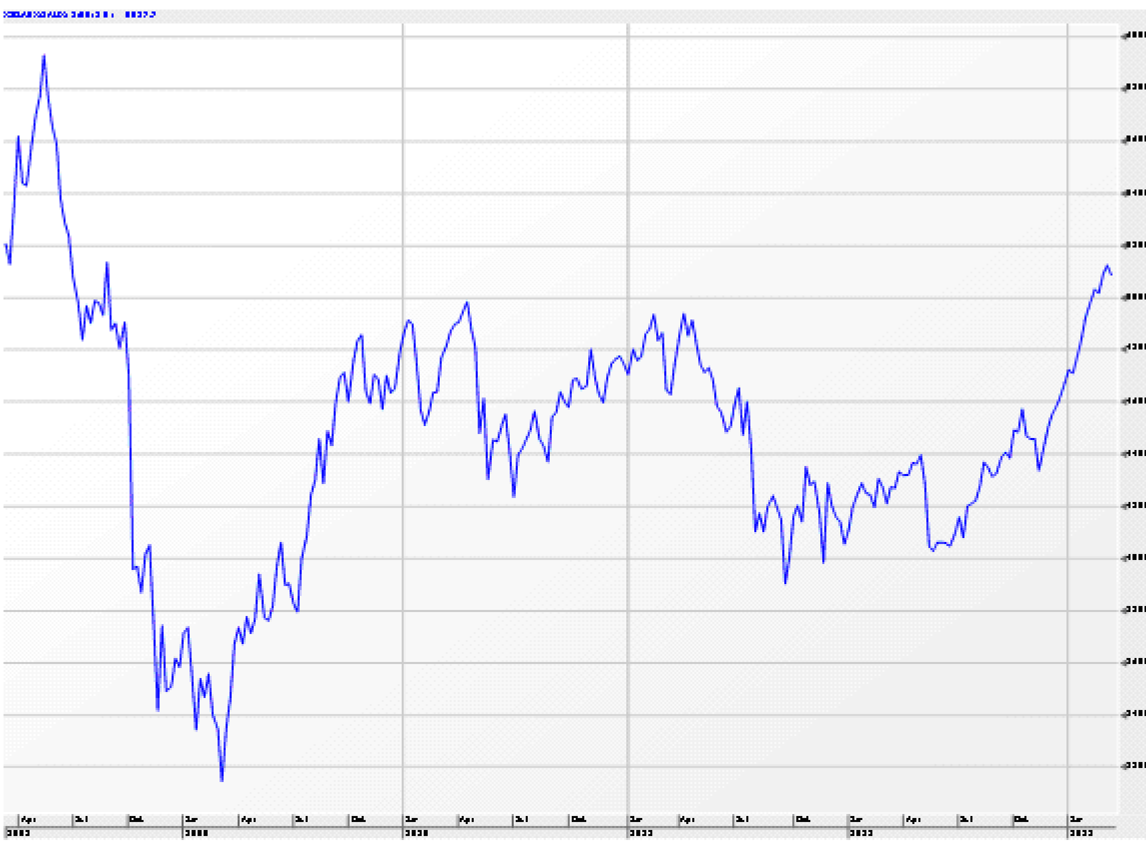
The wall of buying we are referring to is twofold. Firstly, from fund managers. With the equity market rally, investors are just starting to get FOMO (Fear of Missing Out). Money is flowing into equity funds and people are switching their investments up the risk spectrum from bond and cash funds to equity funds. This net inflow into equity funds is in the billions of dollars. Fund managers have a mandate – to invest in shares. They cannot sit on this cash coming into their funds so they are forced to buy. Secondly, as many term deposits mature that were taken out six to twelve months ago at interest rates of 5-6%, investors are now facing new deposits at circa 4% and realise this is only going down. When inflation is running at 2.5%, the real return from term deposits is now more like 1.1% after tax (assuming a 15% super fund tax rate). So some of this money is making its way into shares via self managed super funds or direct portfolio’s. The demand caused by these two factors at a time when there is a “sellers strike” leads to a sharp jump in share prices.

On top of this demand support for shares, general sentiment is improving as people again become comfortable with shares (it has only taken a 10-15% bounce that they have missed!). Arguably over the past two years as fear dominated the psyche of investors, the price to earnings (P/E) ratio of stocks was pushed down as people priced in perpetual earnings headwinds and permanent structural change in many industries. However, with signs of life in the global economy and much of the perceived structural change now looking like it was just cyclical timing, this P/E discount is now been replaced with a more normal (less fearful) P/E multiple. Should earnings show signs of recovering and increasing over the next six months then this P/E expansion will be more than justified and lead to higher share prices.

It may take a year or two, but at some stage the P/E multiples will have gone from discounted, to fair value and ultimately to bullish, as greed will have replaced fear and people start pricing in perpetual growth. Of course this will be towards the tail end of the next bull market.

Before we get back to China and the last great hope of the bears, below is the same chart as above but over a five year period. This is to put into context the recent run up we have had in share prices. Looking at the former chart (which was over a two year period), it looks as though the recent run up we have had is way over extended and due for a substantial pull back. But look at the same chart (ASX200) over a five year period and then a ten year period – see below. As you will see, in context of the medium term picture, our market has not really had that big of a run up. All that we have seen is the fear factor discount that was been applied to shares, removed. Any earnings recovery will lead to further gains.

5 Year Chart of the ASX200



10 Year Chart of the ASX200

Now, onto China and the last great hope of the bears – a China Crash.

For much of the last couple of years, Euro issues aside, the "fast money" was worried about China falling over as they managed their growth rate down in a bid to contain inflation. China's growth last year slowed to circa 8% from well over 10% post GFC. As Australia is seen as very reliant upon China's economic activity, all things China facing were under additional pressure.

During the past couple of years, global "fast money" has had a field day short selling Australian shares that are either China facing, in traditional cyclical industries or related to our property market. Short selling is selling shares you do not own in the expectation / hope that these shares will fall further and you can buy them back cheaper – hence making a profit on the difference. This is still legal, but a dangerous game to play. The banks were the target for quite some time on the global expectation that our property market was due to collapse 30% at any moment – simply because that's what happened in the US. However, despite a softening property market in 2011 and much of 2012, this did not occur and in fact in the final quarter of 2012 the median Australian house price actually rose 3.8%. Seeing this occur, the short sellers in banks were forced to start buying as they realised their efforts to bring down our banks were futile.

At the same time they moved onto our discretionary retailers, believing that the industry was undergoing a permanent structural change and not just a cyclical downturn. But with lower interest rates, strong employment, growing incomes and a historically high savings rate in Australia, retail spending bottomed out in the last half of 2012. Some shorters have continued to add to their bets in this sector, but they have been dead wrong so far and we think likely to be even more wrong in the year ahead.

The one area where the global "fast money" has been short and they haven't (yet) been blown up, is China facing resource stocks. We need to look no further than our two biggest resource companies, BHP and RIO. As we have written about in MBM before, the resources investment boom has or is shortly likely to peak, but this does not mean a crash. China has been able to stabilise its falling growth and has forecast 7.5% growth for the coming years. Exports out of China are up substantially as Europe stabilises and the US continues to defy (academic) logic and grow its way out of trouble.

Our major resource companies are no longer chasing high priced acquisitions or expansionary projects. They are focusing on volume increases and cost out programs, just as the banks and industrial companies did in 2011/12. So if China does not crash, world growth continues to rebound, resource companies lower their cost bases and expand volumes, the global "fast money" will soon be jumping over themselves to buy back their short positions. When short sellers get it wrong it's like watching a herd of sheep try to pass through the farm gate. This at a time when sellers are on a strike means sharp share price reactions. We've seen it in the banks and industrials; now watch it unfold in the big miners. Short selling is dangerous. In a bull market, it's borderline insane!

This time is not different. Markets move in cycles. This market, right now, is showing signs of an early stage bull market. The more sceptics, the better. A famous investor, John Templeton, once said "Bull markets are born on pessimism, grow on scepticism, mature on optimism and die on euphoria". We are likely just seeing the end of the "born on pessimism stage". There is quite a way to go for this bull market to play out.. **Zài jiàn (Goodbye in Mandarin)**

Stock Review - BHP Billiton Ltd (BHP)

BHP is the largest listed company in Australia with a market capitalisation of $115B. BHP is a global diversified miner with its main sources of revenue being Iron Ore, Petroleum, Metallurgical Coal and Copper sales.

BHP is highly leveraged to improving commodity prices in Australian dollar terms. They have substantial organic growth opportunities with most of their capex (capital expenditure) being spent on brownfield exploration (drilling of existing mining areas to expand the known recoverable resource). The only greenfield capex they are undertaking is in copper – which they are very bullish on in the long term due to supply / demand fundamentals.

Our analyst forecasts total revenue for the 2013 financial year of $69B, growing to $77B the following year. This translates to earnings per share of $3.19 in financial year 2014 which based on BHP’s current share price of $35.12 puts it on a P/E of just 11 times with a dividend of $1.20 per share or 3.41% fully franked (4.86% gross – not bad compared to a term deposit yielding just 4%).

At its recent interim result in February, BHP announced they have appointed a successor to CEO Marius Kloppers, Mr Andrew Mackenzie. The new CEO is expected to maintain their corporate strategy of reducing costs and ramping up volume increases across their suite of commodities. We understand Andrew Mackenzie has a strong track record of improving productivity and cost control. BHP has over the past year reduced their controllable costs by US$1.9B. We expect more of this to come.

Our analyst has a $37.19 price target on the stock. We expect this will be quickly ratcheted up as the cost out program continues, volumes are ramped up and China continues to recover.

Mortgage Interest Rates - To Fix or Not to Fix?

A question that only in hindsight can the correct answer be given without doubt. As no one can predict which way interest rates will go over the period ahead and how our economy will perform (which will determine the former), it is impossible to make an unreserved recommendation on when the time is right.

We have been asked this question a few times very recently by clients so thought it may be worthwhile and interesting to some to pen our thoughts on the topic.

Currently, variable mortgage rates are about 5.75%-6.00%. Fixed rates vary depending upon the time frame to be fixed for and from institution to institution. That being said, the major lenders tend to be very similar. Current fixed rates at one of the big four banks today (based on a home equity style of loan) stand at 1 year - 5.19%, 2 year - 5.09%, 3 year - 5.39%, 4 year - 5.74% and 5 year - 5.94%. This is for interest in arrears which is standard. If you prepay interest, which can be a one off benefit for tax deductible loans (eg. rental property), the fixed rates are 0.2% less across the varying terms.

As you can see, all bar one of the fixed rate terms are less than the current variable rates. On average, economists predict we will have two more interest rate cuts this year, with no more to follow. Based on interest rate cuts of 0.25% at a time, this equates to 0.50% total. As we all know, the banks haven't been passing on the full rate cuts though, so we should probably only bank on receiving 0.4% of this.

As it stands, if you were to lock in for 1-3 years today you would be paying a lower interest rate until we get more interest rate cuts. The risk is, our economy deteriorates and the RBA need to cut ruts a lot more (ie. more than is already forecast by the market). The potential upside is our economy improves and we do not get any more interest rate cuts and/or rates start to go back up at some stage in the next few years if you have locked in at fixed rates.

By the time the outlook for our economy looks brighter and further interest rate cuts look unlikely, the fixed rates on offer will be noticeably higher. ie. it's too late to fix in once you think interest rates are going back up any time soon.

As mentioned earlier, it is at best an educated guess. You would think, all things being equal, that we are less likely to have substantial rate cuts from this point (with the cash rate at 3%), than starting from a higher (cash rate) base.

There is no right or wrong answer and everyone's circumstances are different. Feel free to call us to discuss your own situation in more detail.

ASX Market Hours - Easter Period

Please note the reduced ASX trading hours below over the upcoming Easter period. Members of the Martin Bros Team will be available each day the market is open.

- Friday 29th March - Market & Office closed (Good Friday)
- Monday 1st April - Market & Office closed (Easter Monday)
- Tuesday 2nd April - Market returns to normal trading hours
