JM Financial Group

Issue 9: January 2016

Investment Newsletter

Market Performance (As at 31st Jan 2016)	January 2016 (%)	Calendar YTD (%)	1 Year Rolling (%)
S&P All Ords Accum. Index	-5.38	-5.38	-1.80

Month in Review - *A review of events that influenced the share market in January.*

The buoyant mood in markets across December was quickly forgotten in January with the All Ordinaries Index falling over 5% as fears of a sharper slowdown in China were compounded by weakening oil prices and disappointing US economic data.

In fact the start to year was the worst in Wall Street's history with the Dow Jones Industrial Average falling over 6% in the first eight days of trading. Given the increasingly uncertain environment it was no surprise the US Federal Reserve elected to hold rates steady with their commentary pointing to increased caution going forward even opening the door to a potential rate reversal later in the year if required.

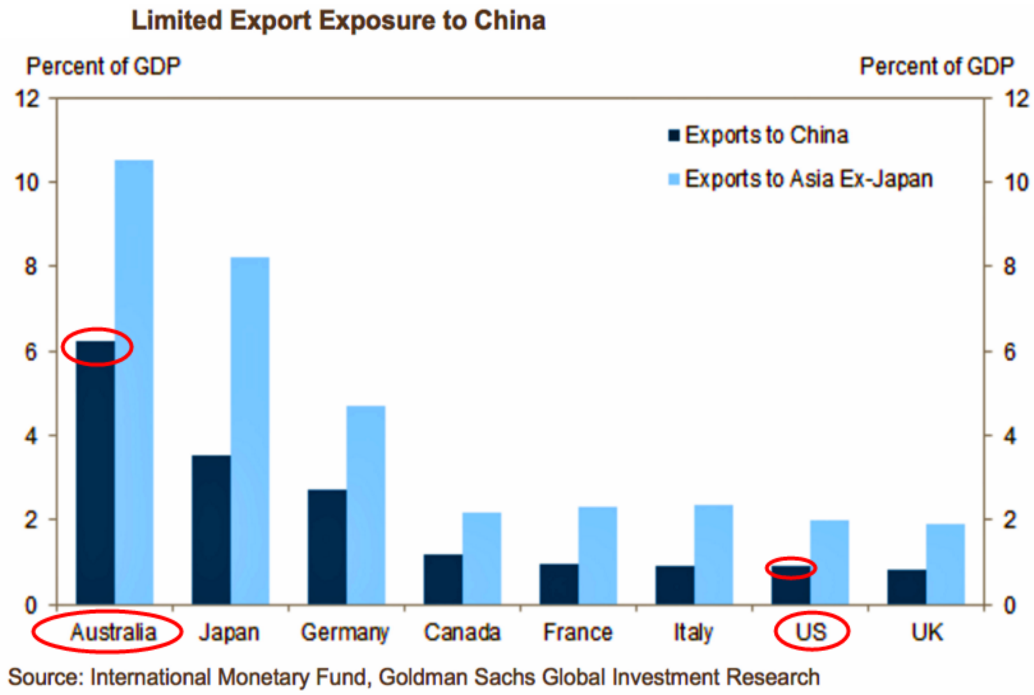
Although Chinese GDP came in at an enviable 6.9% for 2015 this was the lowest growth rate for 25 years and lead to falls in the Chinese Yuan, the Australian dollar and the crude oil price (discussed in more detail later in the newsletter).

In stock specific news Dick Smith's woes finally came to a head with the business going into administration due to poor sales and an unmanageable inventory position. A pertinent reminder for stock market investors about the importance of doing rigorous due diligence when companies are coming out of private equity ownership. Dick Smith wasn't the only retail business to report negative news during the month with earnings downgrades from Godfreys, Lovisa and GUD Holdings as the depreciation of the Australian Dollar (AUD) negatively impacted gross margins.

The disparity between Wesfarmers and Woolworths was again apparent with Woolworth's announcing the closure of its Masters Hardware business whilst Wesfarmers announced its entry into the UK Home Improvement market through the purchase of the UK's second largest home improvement business, "Homebase".

With February heralding the beginning of the Half Yearly reporting season we look forward to market moves being once again driven by company specific fundamentals.

Chart of the Month – *China exposures*



During the month, Goldman Sachs Global Research published the chart to the left in an attempt to highlight how the slowdown in China and the devaluation of the Yuan may not be as bearish for global markets as first thought. As can be seen only 1-1.5% of US, UK and French GDP is consumed by China.

Sadly for Australia the chart highlighted the precarious position for our resource sector. This isn't surprising given our export based economy but it's a sobering reminder of why we prefer to remain underweight resource stocks.

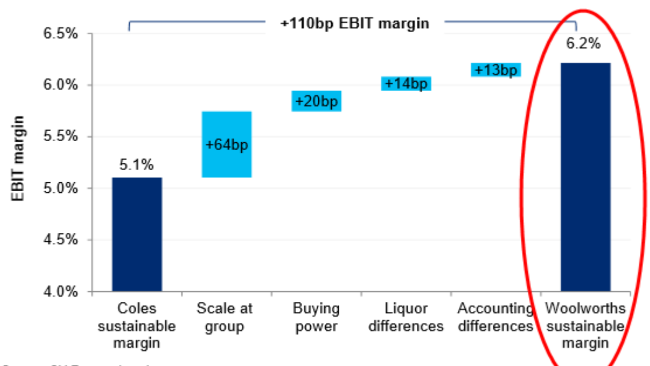
Due Diligence – *A closer look at a company of interest.*

Woolworths - WOW

The last year has been one to forget for Woolworths with its share price falling 20%, its earnings being downgraded 3 times, its CEO resigning and now finally, the announced closure and potential sale of its beleaguered Masters Hardware division.

Although we held off on investing in Woolworths for most of the fall, we unfortunately added it to some portfolios for a short period of time in the middle of the year following the resignation of the CEO in the belief that this would be the catalyst for change. Seven months later and there is still no CEO with the Board now looking offshore for a replacement amid rumours of a lack of domestic candidates prepared to take on the role.

Figure 1. Food & Liquor sustainable EBIT margin - Coles compared with Woolworths



Source: Citi Research estimates

For many years both Coles and Woolworths benefitted from a cosy duopoly with IGA a relatively poor competitor at the fringes. This saw liquor and grocery margins increase to 8% for Woolworths and 5.6% for Coles, both high by world standards. As is often the case when high returns occur for too long, aggressive competitors enter the market which is what Aldi has done to tremendous effect. Although it's still a small competitor, Aldi operates off 4% margins forcing the two large players to improve prices. A great outcome for consumers, less so for Woolworths' bottom line.

The one small piece of good news though was the recent announcement of the closure of Masters which was losing a staggering $170m p.a. Although the financial impact of the sale and closure won't be determined for a further two months it's encouraging to see the Board taking positive steps to arrest the profit decline.

With no CEO, grocery profit margins falling and the exact financial impact of the Masters closure yet to be determined we feel there are a lot of headwinds for Woolworths in the short term. Unlike Wesfarmers it doesn't have the benefit of a Bunnings (arguably the best retail business in Australia) offsetting any margin weakness in its grocery division. Given its size and enviable asset base there is no doubt there will be a time to own Woolworths but we feel the risks are still too high at this stage.

Sector Watch – *Black Gold*

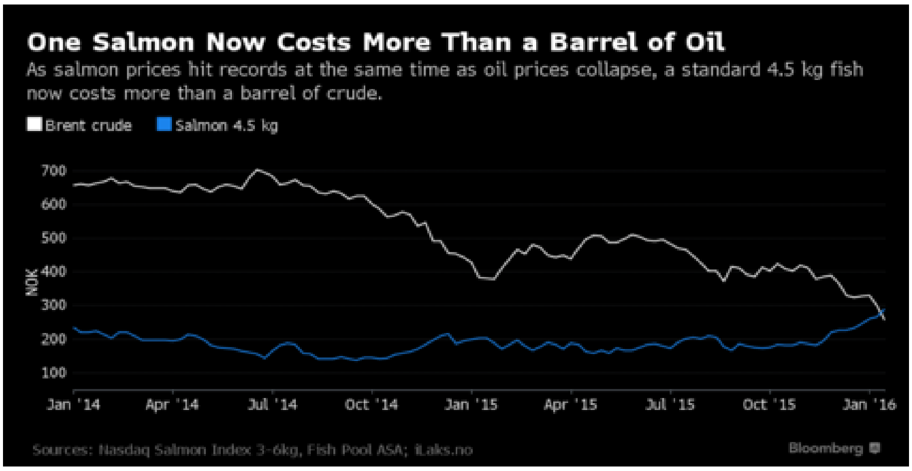
Much has been said about the oil price and quite rightly given a barrel (bbl.) of crude oil now costs less than an average sized (4.5kg) salmon. *(A barrel was worth two times the salmon price a year ago).* That in itself doesn't sound overly impressive until you realise that a barrel contains nearly 159 litres. On an AUD equivalent a $30 US/bbl. oil price translates into a remarkable 27c/litre. A sobering thought when you're filling your car with $1.40/litre petrol.

Further to this, a 1.5L bottle of Mount Franklin Spring Water currently costs $2.05/litre at Coles. Now, no offence to the good people at Mount Franklin and there is the cost of bottling and a retail margin but when a product that falls from the sky for free costs nearly eight times as much as a fuel that is mined from kilometres beneath the earth then something is mispriced.

Whilst the comparisons above are largely tongue-in-cheek they do highlight how savage the oil price fall has been.

A culmination of weak Chinese demand coupled with increasing OPEC supplies, record US shale oil production and an easing of Iranian sanctions have led to a 70% fall in the price of crude oil in less than 2 years.

Although clients benefitted greatly from not holding pure oil and gas companies in 2015 we continue to monitor the sector closely for signs of a rebound.



Unlike many commentators we don't seek to forecast when prices may bottom but instead focus on movements in oil inventories and any supply cuts from large producers. As recently as last week US crude inventories reached their highest levels on record with 494m barrels of surplus production. When combined with OPEC's 2.9bn barrel inventory position it would appear that the market will remain oversupplied for quite some time to come.

With Iranian sanctions being lifted and talk of Russia and OPEC discussing potential supply reductions it's clear that there are multiple political levers at play into which we, and most other commentators, have very little insight. Although the oil price appears cheap versus recent history we remaining cautious, preferring to see how the market plays out rather than attempting to forecast the often unforecastable.