JM Financial Group

Issue 2: June 2015

Investment Newsletter

Market Performance (As at 30th June 2015)	June 2015	Calendar YTD	1 Year
S&P ASX 200 Accum. Index	-5.30%	3.10%	5.68%

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

The likelihood of Greece exiting the Eurozone escalated considerably in the last week of June with the country defaulting on a repayment to the IMF. The Greek government was forced to introduce limits on the value of bank withdrawals to preserve cash. The key concern is that a Greek exit could have a contagion effect on Europe, forcing up the cost of debt for other poorly positioned countries such as Spain, Italy and even France. The Greek government held a referendum on 5 July to gauge the public's support for its hard-line stance against austerity. At the time of writing, 90% of the votes have been counted with 61% voting No. We discuss our thoughts on Greece in more detail later in this note.

Australian March quarter GDP rose 0.90% which was above expectations of 0.70%. The reading takes annual GDP growth to 2.3%. The stronger reading saw the A$ rise over 2% on the day despite indications consumers are drawing down on savings. Weak wage growth and poor productivity are likely to continue to stymie GDP, whilst the housing market remains extremely buoyant. Overall we see increasing difficulty for the RBA to further reduce interest rates.

Australia recorded its largest ever trade deficit in April at $3.9bn versus expectations of a $2.1bn deficit after 10 years of negotiating, Australia finally signed the landmark free-trade agreement (FTA) with China. The government forecasts that the combined China, Japan and Korea FTAs will boost Australian exports to the three countries by 11.1% and increase imports by 8.3% through to 2035. Exports to these countries are expected to grow in value by approximately $20bn.

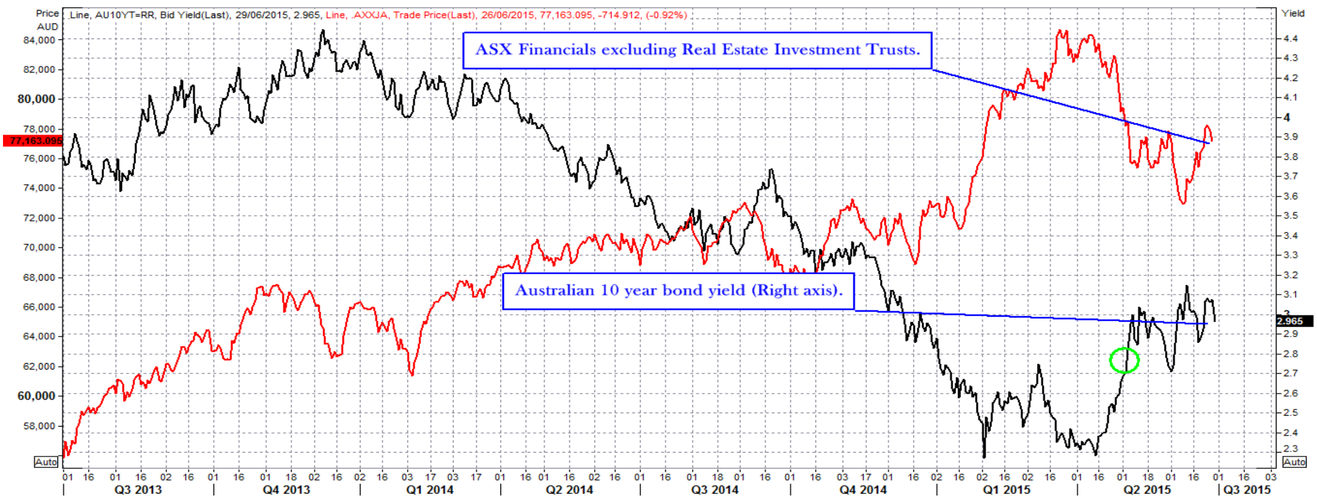
The Bureau of Meteorology escalated its El Nino warnings throughout the month indicating a heightened expectation of below average rainfall for southern and eastern Australia, which in turn could lead to drought conditions developing in 2015.

The US economy continued to experience a strong recovery with stronger jobs data, better than expected existing and new home sales and a sharp recovery in retail sales. Broad market expectations are for the US Federal Reserve to increase interest rates in September. If it occurs this will be the first increase in 9 years.

Chart of the Month

The Australian 10 year bond yield in black versus the ASX Financials stocks excluding Real Estate Investment Trusts in red.

Despite the RBA cutting interest rates in early May (timing highlighted by the green circle), the Australian 10 year bond yield has risen to 2.96%. Part of the reason has been increasing expectations the US Federal Reserve will raise interest rates for the first time in 9 years. Another reason is the growing expectation that the RBA is unlikely to cut interest rates again while the housing market remains stubbornly high. We remain cautious on the banking sector in anticipation that the housing market is due a correction.



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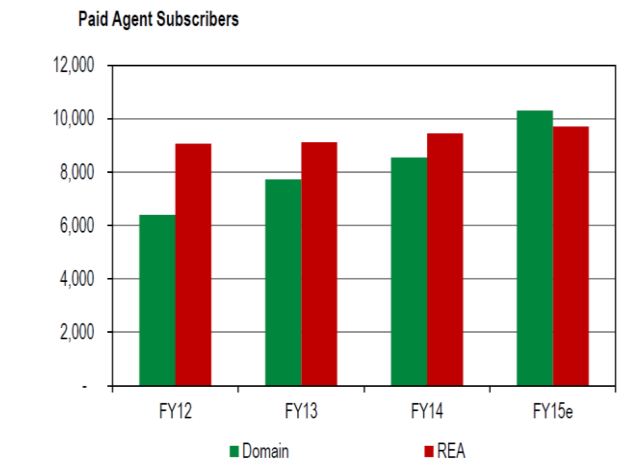
Due Diligence – *A closer look at a company of interest.*

Fairfax Media Ltd (FXJ): Not just a newspaper.

2015 is FXJ CEO Greg Hywood's fourth year at the helm. Hywood has executed a radical plan to re-shape FXJ, not only to survive the online assault on print media, but to embrace and thrive in the non-print world.

Hywood is methodically turning the FXJ business around. Within the FXJ structure he positioned the key growth asset, Domain, as a stand-alone entity, unencumbered by the drag caused by the downsizing and restructuring occurring in the rest of the business. The strategy has succeeded, allowing Domain to achieve strong market share and digital growth rate gains against the industry leader REA Group (valued at $5.15bn) See adjacent chart. FXJ is valued at $2bn.

The incentive for Hywood to deliver continued success for Domain is significant with REA's Australian earnings currently three times those of Domain. We have seen broker valuations for Domain range from $1.13 billion to $1.4billion.



Source: Citi Research

The company has also achieved meaningful online penetration with both The Age and the SMH, reaching 30% of Australia's iPad population. Within the old-world news print businesses Hywood successfully realigned the running costs with the technology-driven step-down in advertising revenues. This resulted in a sharp lift in profits for the Age and the SMH in 2014.

These successes have ensured FXJ has a valuable digital future. Including the very successful AFR Group and the Macquarie radio assets we believe FXJ has developed a very strong Australian-content business which should deliver strong returns for shareholders.

Markets move in mysterious ways:

Despite only a very remote risk of contagion from the Greece fiasco, it did not stop share markets around the world from diving in June. How this will end remains to be seen, however with all the misinformation and disinformation circulating about what may transpire in the event Greece exits the Eurozone, it is always useful to take a look at the facts:

The value of Greek GDP is US$246bn which represents 0.26% of global GDP, it's the equivalent of 16% of Australian GDP and can be completely replaced by less than 8.5 days of Chinese GDP. Greece is Australia's 68th largest trading partner with 2-way trade totalling $203m per year. Overall a Greek exit from the Eurozone poses no great direct risk to the Australian economy.

When Greece was accepted into the EU it did not disclose that it had an exposure to a derivative product which served to mask the true extent of its debt. This allowed it to circumvent the Maastricht deficit rules allowing the illegitimate Greece to gain EU entry by stealth. Greece was clearly not entitled to become part of the EU from the very start. Logically a Greek exit should eventually be seen as a positive for the EU and the Euro.

Modern day technology allows thousands of media platforms to continuously bombard us with largely unchecked opinion and information. For example a media article recently suggested the situation in Greece will serve as the lesson and potentially the catalyst for the break-up of the EU. The author's key argument was that Greece had long ago taken a knife to its overspending habits, its generous pensions and its big public service. He went on to point out that the real problem for Greece became the flow-on effect of those cuts which exacerbated the problem by further shrinking the economy. The crux of his argument then focussed entirely on his view that if Greece had its own currency it would have devalued with the economic shrinkage allowing the country to set in place an export driven economic recovery. In other words the single currency Euro was to blame for Greece's demise. It is articles like this that can drive panic-like behaviour in markets.

We believe the author's case is flawed in that having an export product priced in Euro would actually be a genuine benefit in the event Greece were to embark on an export driven recovery. In reality what would need to be done would be for the exporter to price the product competitively. A discounted product in a single currency region like Europe should standout like a beacon to potential buyers. The author also failed to address the issue of inflation which generally arises when a currency materially devalues, pressuring interest rates higher. Under the Euro this would be unlikely, allowing Greece to operate under a more user-friendly interest rate environment.

We wanted to share these observations and thoughts with you as they highlight that share prices and markets can move for a multitude of reasons. Many do not involve profit, logic or fact. Despite that we do respect anything that can cause extreme movements in the value of your investments, however many of these are short-lived and more often than not, best ignored.