JM Financial Group

Issue 22: February 2017

Investment Newsletter

Market Performance (As at 28th February 2017)	Month To Date (%)	Calendar YTD (%)	1 Year Rolling (%)
S&P - All Ords Accum. Index	+2.09	+1.31	+21.33

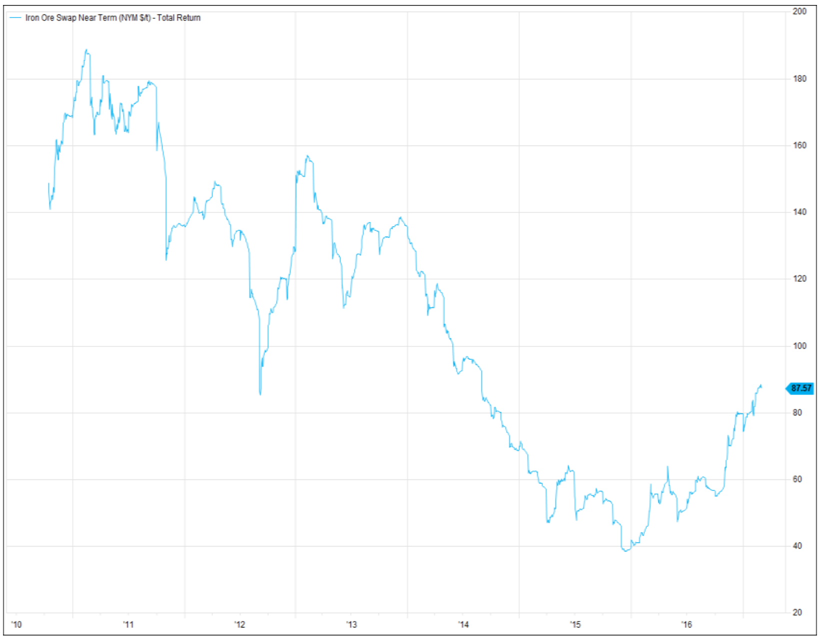
***Month in Review** – A review of events that influenced the share market in February.*

February saw the ASX 200 rise 2.3% and the Small Ords Index rise 1.3%, reversing losses experienced in January. The Dow Jones surged through 20,000 points, finishing the month above 20,850. Reporting season proved to be good, with only a limited number of sizeable negative surprises. Confession season through January dealt with several negative surprises: Telstra & Brambles amongst the majors with iSentia, ARB Corporation, Ardent Leisure, Spotless Group, and Retail Food Group amongst some of the larger Small Ords companies. Guidance statements were generally in line with or ahead of expectations. The market was stronger in the first half of the month, retreating partially later in the month.

The Resource Sector eased in February, having been in a strong upward trend for a full 12 months. Commodity prices were generally stronger through the month with iron ore price up ~10% and nickel a similar amount. Copper rose marginally but energy prices weakened slightly. The Resource Sector does not look expensive on current estimates but estimates are now based on stronger commodity prices and as such risks have increased. If improved U.S. growth expectations are achieved, stronger commodity prices may be maintained through 2017. Iron Ore prices may be harder to maintain through 2017 following inventory re-stocking in China and growing global supply. Downside risks in the Iron Ore space would seem much higher than other resources but there are no signs of a price reversal at this stage.

Market PE multiples above 16x in FY17 based on forecast EPS growth ~8% is not excessive, as we highlighted last month, particularly if that is backed up by a further 7-8% growth in FY18 as is currently forecast by the market. If Resources are excluded from the equation, along with lower PER Banks (13-14x avg, Property Trusts, and highly geared Utilities, the underlying multiple for Industrial companies is in the 19-20x PER range. Solid growth needs to be achieved to support such multiples but within the smaller cap space both higher growth and lower multiples provide attractive opportunities in a growth backdrop.

Chart of the Month – The Rise of Iron Ore



Iron Ore has made a solid recovery, more than doubling from a low base. Some recovery needed to occur. Prices around US$40/t were unsustainable given lowest cost global operators in Australia, BHP and RIO, have all-in costs in excess of US$30/t for their high grade ore production. Many global peers, by comparison, have cost structures well north of US$50/t for what is often considered inferior grade ore.

Whilst one can never say never, it is difficult to envisage iron ore prices back above US$160/t as seen in 2010 and 2011. Cost structures globally have come down dramatically since 2012, coinciding with rising supply and falling prices, with costs falling by as much as 50%. High end cost operators are typically in the US$60-80/t range.

As it stands today even the highest cost operators are generating returns and this should drive further growth in supply over time. While the iron ore price may go higher it could well be capped in the vicinity of US$100/t.

JM Financial Group
AFSL 238397 ABN 68 007 364 132

Level 8, 140 Bourke St, Melbourne, VIC, 3000
Ph: +61 3 9627 9900

Web: www.jmfg.com.au
Email: enquiries@jmfg.com.au

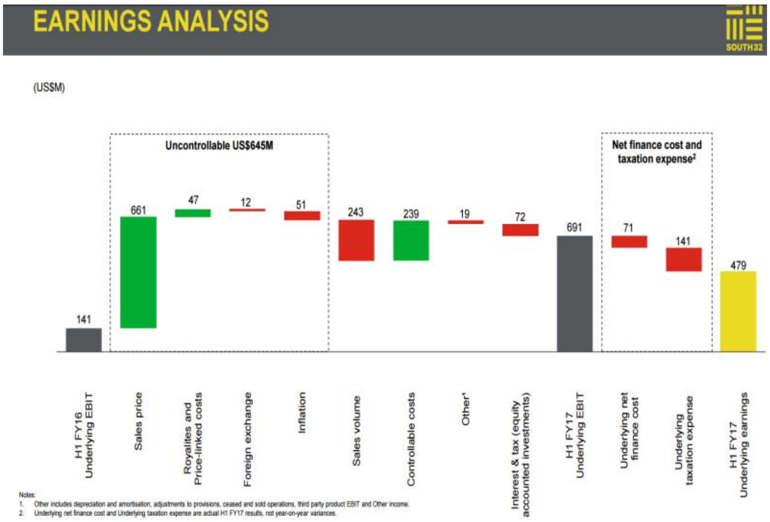
Due Diligence – *a closer look at a stock of interest*

South 32 (S32)

South 32 was spun out of BHP in 2015 and houses Alumina, Thermal & Metallurgical Coal, and Manganese assets along with nickel, silver, lead, and zinc assets. Operations are located in Australia, South Africa, and South America.

The Manganese and Coal operations each represent over 30% of the current earnings base, while Alumina accounts for around 20% with the balance coming from the remaining base metal operations.

Underlying EBIT in 1H17 climbed to $691m from $141m in 1H16 with the growth achieved largely on higher commodity prices. Sales volumes actually fell during the half but this impact was largely offset by a reduction in controllable costs. Immediate earnings prospects will be driven by sales prices and this should lead to strong earnings growth in FY17.



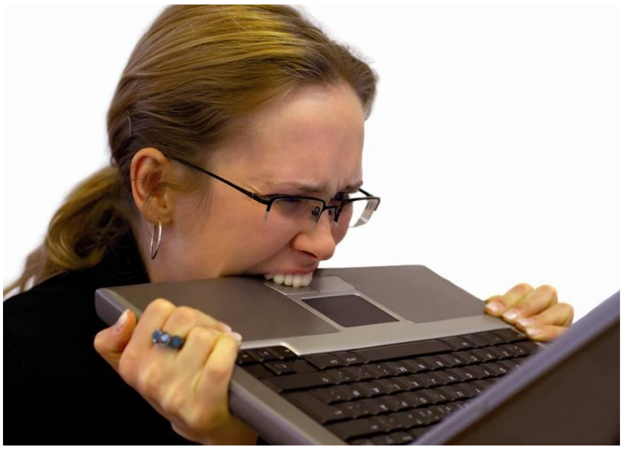
While South 32 has a number of strategies to improve earnings performance through optimising operations (increase production and reduce costs) as well as extending asset life, these will only impact at the margin of operations. Commodity price movements for the foreseeable future will far outweigh earnings volatility caused by non-price movements. The company however continues to identify new opportunities to acquire existing operating assets as well as early stage exploration opportunities which may ultimately add to the earnings potential of the company.

Risk On / Risk Off

“Risk On” / “Risk Off” are terms often used to describe the mood of the market. “Risk On” reflects an optimistic period in the market where higher economic, and therefore earnings, growth is achieved or expected to be achieved in the immediate future. “Risk Off” is essentially the reverse, a cautious period reflecting lower economic and earnings growth in the current environment or expected to occur in the immediate future. “Risk On” stocks typically have a higher beta than “Risk Off” stocks.

Establishing portfolio settings around “Risk On” / “Risk Off” periods can be crucial to achieving excess returns. Lower growth sectors, with more stable earnings streams through the cycle, include REITs, Telecommunications, Utilities, Healthcare, and Consumer Staples. These are typically the sectors where overweight positions are taken through “Risk Off’ periods, whilst “Risk On” sectors would include Resources, Materials, Consumer Discretion, I.T., and Industrials. Return outcomes by sector can however be influenced by stock specific factors where those stocks make up a large component of the index. Hence achieving excess returns is not just a function of the economic backdrop but a proper assessment of company specific factors as well. The low growth environment experienced through much of this decade has coincided with declining short and long interest rates, the latter only reversing since mid-2016. Up until that point the environment suited a “Risk Off” approach.

During that period major underperforming sectors included Resources and all of its components, through to January 2016. Whilst this may have been expected, Consumer Discretion outperformed whilst Consumer Staples underperformed. The Consumer Discretionary sector performed well for two major reasons. Falling interest rates benefited the most highly geared, highest consumer discretionary spending demographic, whereas growth while slow, was enough to maintain and even improve employment levels. The weakness in Consumer Staples was company specific. New competition in the supermarkets segment combined with the troublesome home improvement operations had a profound impact on Woolworths, whilst Wesfarmers had exposure to resource and Industrial assets along with its supermarket operations.



Tracking Risk On / Risk Off Market Moods – trying to time the Market can lead to frustration (and an unusual appetite!)

Major outperforming sectors until midway through 2016 included REITs, Utilities and Healthcare, all of which have partially reversed since then with a rise in interest rates. Financials had been major outperformers until April 2015 when capital adequacy changes affected the rate of earnings growth and performance. More recently they have begun to outperform again.