JM Financial Group

Issue 31: November 2017

Investment Newsletter

Market Performance (As at 30th November 2017)	Month To Date (%)	Calendar YTD (%)	1 Year Rolling (%)	3 Years Rolling (%)
S&P - All Ords Accum. Index	+1.91	+10.23	+14.83	+30.19

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

The All Ordinaries Accumulation Index increased 1.91% for the month, rising 14.83% over the twelve-month period to end November. Strongest sectors included Energy +6.0%, I.T. +5.8%, Property Trusts +5.6%, and Consumer Staples +4.7%. The small end of the market performed well, with the ASX Small Ordinaries advancing 3.9%. The market was held back by the Financials sector, which was flat for the month after incorporating dividend entitlements from ANZ, Westpac, and NAB. The government announced a royal commission into the banking sector on the final day of the month – however, this had little impact on the sector with the 0.3% Financials sector decline on the day in line with the broader market. The Telecommunications sector fell 1.5% in November, which saw Telstra trading at 5-year lows.

On the commodity front, oil prices rose 6-7% to ~US$57/b and iron ore lifted a further 5-6% to around US$65/t at month-end. Base metals continue to trade at relatively high levels in A$ terms, and, with strong A$ beef, sheep, and wool prices, the Australian economy appears to be well placed against a backdrop of improving global growth. The large Materials companies recovered in October, with BHP Billiton rising 3% and Rio Tinto up 4%. Fortescue Metals Group fell a further 10%, following the dividend-adjusted fall of 9% in September.

Last month, we highlighted that, from a low point in February 2016, the All Ordinaries Accumulation Index had risen over 30%, and that the 12-month forward Price to Earnings Ratio (PER) had increased from 15.2x to 16.1x, based on consensus *Factset* data. Clearly, there has been strong earnings growth over the past 18 months, along with upgrades to forecasts in the materials space, particularly iron ore.

We have some concerns around the current high forward PER multiple for the market – however, strong economic growth and an expectation for minimal interest rate increases should translate into further, albeit modest, rises in equity markets. Our thinking, at this stage, is that a retraction in the forward 12-month PER is more likely to come from earnings growth rather than a market decline, and the forward 12-month PER may well hold up whilst robust earnings growth is achieved. The caveat, of course, is any left-field event that disrupts the growth prospects of any of the major economies.

Chart/Table of the Month – Global Economic Forecasts

Region Economic Summary

	Real GDP	CPI	Unemployment Rate	Current Account	Govt Debt
	% vs year ago	% vs year ago	Percent	% of GDP	% of GDP
China	6.8	1.9	4.0	1.2	15.5
European Union	2.5	1.7	7.5	-	82.1
Euro Zone	2.5	1.4	8.9	4.3	87.9
France	2.2	1.0	9.7	-1.6	97.9
Germany	2.8	1.5	3.6	8.2	64.8
India	5.7	2.9	5.0	-2.4	46.1
Italy	1.8	1.0	11.1	3.5	134.7
Japan	1.6	0.7	2.8	4.0	197.9
United Kingdom	1.5	3.0	4.3	-4.6	89.2
United States	2.3	2.0	4.1	-2.6	105.0

Source: FactSet Economics Standardized Database

We last updated the Global Economic Factors table in June. Since then, there has been a marked improvement in global economic conditions. Real GDP growth across Europe has lifted by around 0.5% to 2.5% – France is up from 1.1% to 2.2% and Germany up from 1.7% to 2.8%.

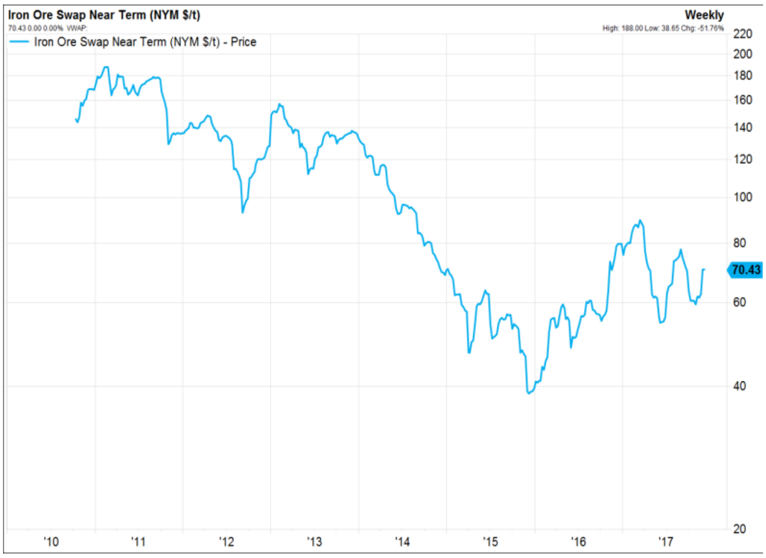
In addition, the U.S. is up from 2.1% to 2.3% and Japan is up from 1.3% to 1.6%. China continues to grow in the high 6% range and, in India, while growth has moderated slightly from 6.1% to 5.7%, the overall rate is still high. Only the UK has substantially deteriorated, with growth dropping from 2.0% to 1.5%. In addition to the improvement in Real GDP growth, inflation rates have generally increased, but remain within comfortable levels.

Improving global growth is no doubt a major factor behind rising commodity prices, along with a lack of new supply for many hard commodities. Given the lead times to prove up and develop many of the base metals (copper, lead, zinc, nickel), should higher global growth continue, it would be reasonable to expect commodity prices to remain buoyant.

Higher global growth should be the catalyst for stronger earnings growth in Australia, which, in turn, should support higher than normal forward PER multiples, as outlined in last month's newsletter.

Due Diligence – *A closer look at iron ore*

Bears assume a long term iron ore price of US$45/t. There are strong arguments for a long-term bear market based on new supply (est. 200Mt over the next 4 years) outstripping demand growth. Price strength in CY16 and early CY17 was attributed to bans on Indian production, increased Chinese infrastructure spend and restocking from low levels. The subsequent correction back under US$60/t through mid CY17 seemed to validate the previous arguments explaining the price strength through CY16 and the early part of CY17.

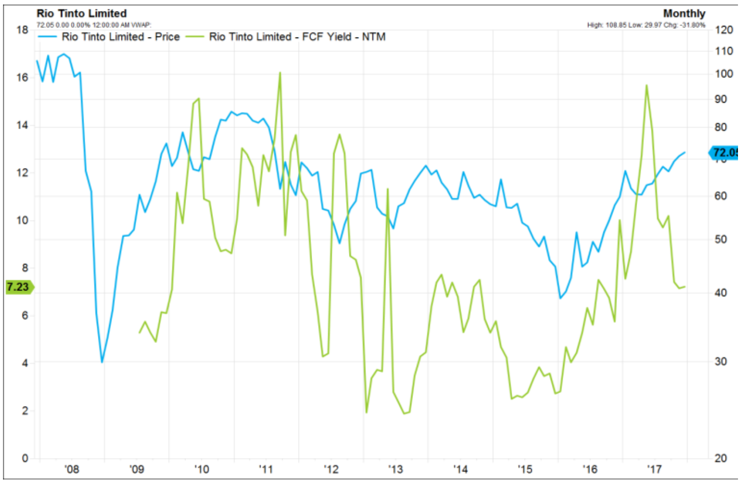


With a degree of volatility, the US$ price is moving higher again, most recently pushing toward US$70/t. We attribute this to improving global growth, but, even if this continues, there is no guarantee that the iron ore price will hold up, given the ongoing supply growth over the next few years. Volatility may continue to be a feature of the market.

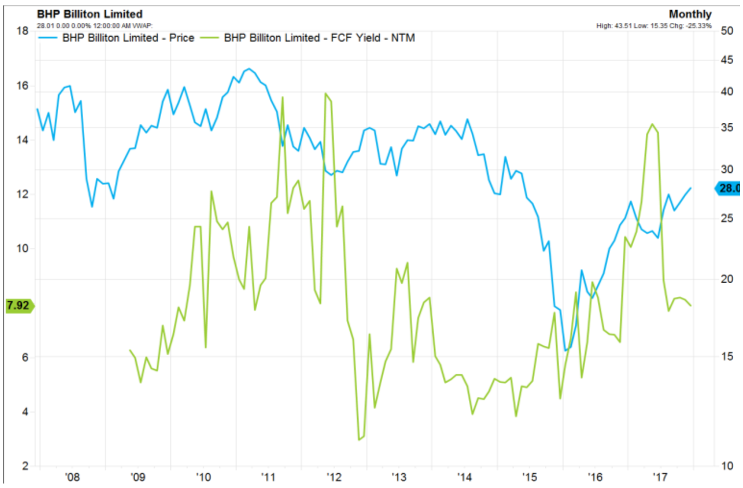
It does seem unlikely, however, that iron ore could push back toward US$100/t given the combination of declining production costs and rising supply. If it does, we suggest it would only be a short-term occurrence. For BHP Billiton, it is not just about iron ore. In FY17, iron ore generated ~55% of BHP's EBIT, with coal generating ~25%, copper ~15%, and petroleum ~5%. For Rio Tinto, the importance of iron ore is far greater, generating ~70% of EBIT in FY17, with the balance split evenly between aluminium and energy/minerals. Based on the current iron ore, energy, and base metal prices, BHP and RIO should both generate solid earnings growth in FY18.

Major Miners & Earnings Yields

Despite the positive earnings outlook for both BHP Billiton and Rio Tinto, we have recently moved to a modestly underweight position in both companies in each of our large capitalisation portfolio strategies. We have done this on the back of rising share prices. Our preference is to have an exposure bias toward base metal resource businesses, where supply risks are lower and longer-dated than supply risks in iron ore.



With the recent price strength for BHP and RIO, their rolling free cash flow yields over the next 12 months have both declined dramatically. For BHP and RIO, it has moderated from over 15%, earlier in the year, to 7-8%, based on current *FactSet* consensus data. Several factors have contributed to the decline.



These factors include: A 20%+ rally in share prices; higher capital expenditure costs in the forward 12 months versus prior; and brokers forecasting a decline in the forward iron ore price. On this last point, and given the recent surge in the ore price, there is every likelihood we will see ongoing upgrades to forecasts through the year. Actual free cash flow yields achieved over the next 12 months may well be nearer 10% than the 7-8% consensus forecasts.

Nevertheless, the risk/return on both BHP and RIO has changed markedly from earlier in the year. We are reluctant to move aggressively underweight given the improving economic backdrop, which could drive ore prices higher for a period.