JMME

THE MARKET OUTLOOK 2016: THE SEARCH FOR GROWTH

with Cameron Diffey, Director - Financial Advisory

The themes
Interest rates are likely to remain lower for longer. Investors are searching for yield. Recent privatisations of public sector assets demonstrates demand from governments attempting to pay for promises made and from investors demanding diversified cashflow. Residential construction is strong as is commercial property with properties changing hands at yields below 5%. Banks are restricting lending to residential investors and certain commercial property sectors.

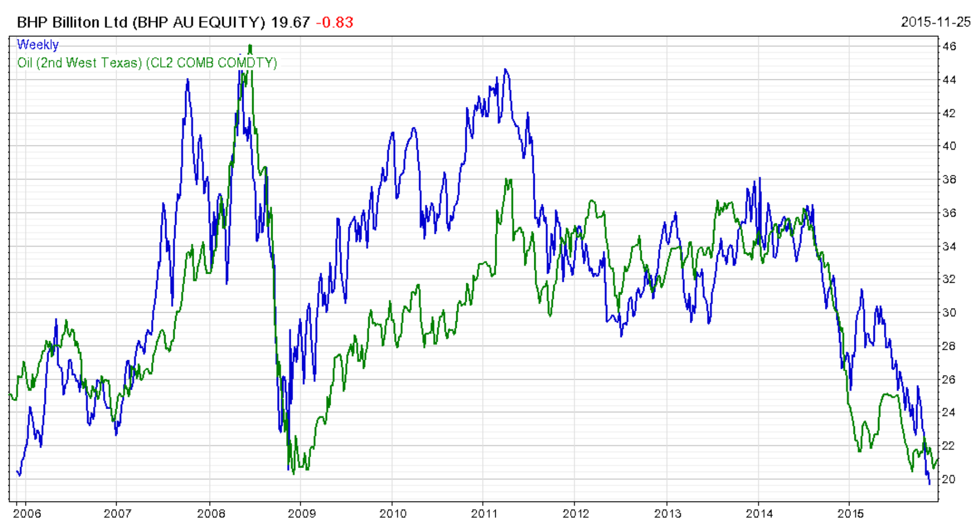
Commodity prices: Oil, natural gas, copper, iron ore, coal are in a slump; it has been 3 long years and looks like it will continue in to 2016. Demand growth rates peaked in 2012, now there are a number of headwinds: global industrial production is slowing, industries are digesting a period of heavy capital investment that has now led to excess capacity and oversupply. The price response is evident.

In the Australian sharemarket the big four banks (ANZ, CBA, NAB and Westpac), BHP, Telstra, Wesfarmers (owner of Coles and Bunnings) and Woolworths represent 45% of the ASX200 and they have a big impact on our market. One of the advantages that the aforementioned companies have is their dominant market positions in their respective industries and how management adapts to increased competition is one of their biggest challenges.

The big four banks face some challenges including reductions in their leverage ratios and the fact that Australian banks have a return on equity near double that of their global peers. Who pays for that return? Woolworths has faced increased competition from a revived Coles and the emergence of Aldi. The once enviable profit margins of Woolworths are falling and the share price has followed.

BHP is weathering the storm of the commodity price cycle and we have no doubt that under $20 there will be investors looking to buy the shares for a number of reasons. The reality is that mining companies are a cyclical business, long live the cycle, and they are now responding by cutting capital expenditure and operating costs which will keep commodity prices lower for a while longer.

The chart below shows the BHP share price relative to the oil price. BHP is not just iron ore, it has significant oil and gas assets. We cannot predict the bottom and turnaround. Demand for oil is less volatile than that for iron ore and the supply-demand balance usually returns quickly. There is clear evidence that US shale oil production is starting to decline, while OPEC keep pumping because they have to; most OPEC members are heavily reliant on oil revenue to manage their economies. In iron ore the supply demand balance could take decades.



We do know that China is in a transition from high capital investment to consumption. The growth in Chinese consumption is a major investment theme and in part explains the agribusiness 'food bowl' push that you hear about. A lot of foreign investors are looking for ways to invest into the Chinese consumer theme and the food supply chain is one approach.

Another major investment theme that is likely to continue is the ageing population and growth in healthcare demand in various forms. Blackmores, the vitamin company, this time last year traded around $30 and at time of writing $188. We are simply living longer and will demand more healthcare services and products that will keep us healthier. The private hospital operators (Ramsay Healthcare and Healthscope), pathology provider (Sonic Healthcare) and more specialised companies (CSL) are all worth considering, preferably on a pullback in their current share prices.

A third theme is premium smartphones and their operating platforms. Think Apple and its iOS platform and other companies that are involved in 3G/4G wireless patents. There is strong growth in demand for wireless connectivity. Not many predictions above, just observations on the current state of play.

Another year passes by, wishing you well over the upcoming holiday period.