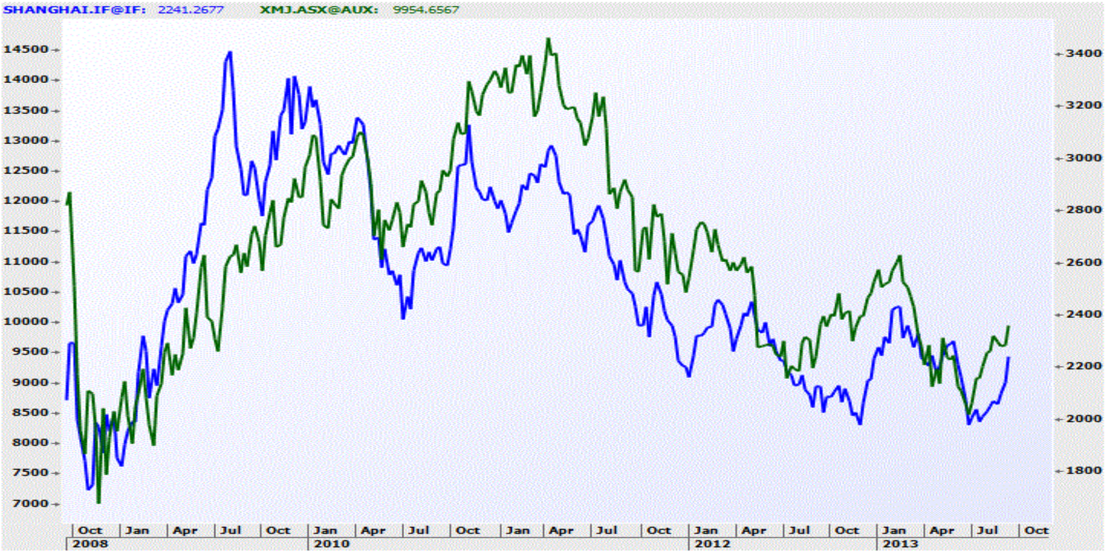
China & Australian Resource Companies – in Lockstep

The share price performance of Australian resource companies over calendar 2013 has suffered at the hands of softer than expected Chinese growth (which in turn had an impact on commodity prices) together with credit market concerns in that same country. Recent growth figures out of China indicated a tick up in economic activity with the September quarter GDP up to 7.8%pa from 7.5%pa the previous quarter. The close-knit relationship between the fortunes of the Chinese share market and our own resource companies is evidenced below:



Blue-Chinese Share Market **Green**-Australian Resources Index

Brokers and analysts alike are now "falling back in love" with the big miners. Everyone's finally starting to realise the magnitude of surplus cashflow BHP & RIO will have at their disposal over the next few years. In a recent research paper from Macquarie Equities the penny finally seems to have dropped under the heading …"After Capex comes the Production". They go on to say that "after 10 years of heavy investment and peak cycle acquisitions, the market has perhaps lost track of the diversified miners imminent jump in free cash generation. Under our forecasts, BHP generates un-allocated free cashflow (over and above dividends and spending plans) of US$38bn (or 22% of current market capitalisation) over the remainder of this decade. Similarly, RIO generates US$49bn (or 49% of its current market capitalisation)." When Macquarie run these numbers through their valuation models, they conclude that "the market is ascribing a heavy discount to the miners future free cash flow (and hence) the potential share price upside from getting capital management right is huge." Their current 12 month price targets for BHP and RIO are $43 and $81 respectively.

OUTLOOK

One thing we have noticed over recent months with the plethora of research material that crosses our desks every day is that there is an increasing propensity for analysts to be talking about medium to longer-term bull markets. There are still the usual doomsayers, but they seem to be dropping in number and (importantly) receiving less coverage in the mainstream press – again, a reflection of improving sentiment.

The market seems to have run on from the technical highs we were expecting in early October. The momentum indicators are touching over-bought levels and we may see some type of pullback over the coming weeks (or possibly just some type of consolidation). However, with sentiment and liquidity supporting equities, we expect any move down will be quite shallow. Other factors that are (or will be) supportive of equities include:

- We are moving into a seasonally positive time for equities – the calendar says "buy".
- US economic data continues its steady improvement.
- The "no taper" decision in the US will provide liquidity that will find its way in to equities.
- Whilst the AUD has moved up somewhat over the past month or so (largely on the no taper decision) we expect the AUD will drift lower over 2014, benefiting most sectors of the Australian economy.
- We believe the RBA "owes" the Australian economy one more rate cut before the end of the year.
- Commodity prices are likely to remain around current levels (supporting resource company share prices and hence the ASX200 into 2014).
- Forward Price Earnings (PE) ratios are not overly stretched
- Profit expectations for upcoming company reporting seasons (in the US and here in Australia) are only moderate, at best, with scope to surprise on the upside.

ASSET ALLOCATIONS

We are looking to position client portfolios as follows:

- **Australian Equities (Slightly Overweight):** We remain cautiously constructive on Australian stocks, particularly as we move into the latter part of 2013. If the currency remains at or below current levels and the RBA delivers a further rate cut, the next 9-12 months could be very profitable for Australian equities. Resource stocks and small caps represent a longer-term buying opportunity.
- **Global Equities (Slightly Overweight):** The no taper decision in the US will ensure liquidity to support global equity markets over the medium term.
- **Property (Underweight):** Listed Property has clearly benefited from the flight to yield, but now appears to be in a correction phase. Later in the cycle, falling interest rates should flow through into firmer prices.
- **Fixed Interest (Neutral):** Listed income securities continue to be an attractive fixed interest investment, particularly when compared to term deposits. Given the level of interest rates, it is preferable to hold a little less cash and a little more in income securities as part of any defensive allocation in portfolios.
- **Cash (Slightly Underweight):** As a result of our positions in other asset classes, cash is presently slightly underweight.

Regards

Andrew & Stephen
25 October 2013