Ralton Monthly Market Update: February 2014
Reporting Season....more to be pleased with than not

RALTON ASSET MANAGEMENT

- The Australian share market performed strongly during February in response to a surprisingly positive reporting season, outperforming the US market for the second consecutive month.
- There was no major economic data influencing the market during the month. The RBA left interest rates on hold. Domestic economic data released during February was slightly softer than expected.
- The best performing sector in February was Consumer Discretionary, followed by Information Technology. The worst performing sectors were Telecommunications and Healthcare.
- This month we take a look at the broader implications of the February reporting season. On the whole, reporting season was better than the market had anticipated, but there was not a lot of evidence of a recovery in revenue growth; rather, it was driven by cost reductions, lower interest expense, and the declining currency.

Market Update

Returns to 31 Oct 2013	Index	1m	1yr
Australian Shares	S&P/ASX 300	+4.9%	10.2%
ASX Small Companies	S&P/ASX Small Ords	+5.0%	-3.6%
US Shares (USD)	US S&P 500	+4.3%	+22.8%

The S&P/ASX 300 accumulation index delivered a return of 4.9% in February, more than offsetting the loss of 3% in January. The Australian market outperformed the US market with the S&P500 finishing the month up 4.3%. The US market was also buoyed by a positive response to reporting season, and the Euro zone also delivered a solid performance, whilst key emerging markets, Brazil and China, again lagged.

There was limited relevant economic news during February. The RBA left rates unchanged again at 2.50%, as expected, but removed its easing bias from the commentary. The Australian government softened up voters for a tough budget in May. If the budget follows the pattern from the previous government, the hard decisions - those likely to hit economic growth (and voter pockets) - will be pushed out into the later years. For the government to go hard at repairing the budget in the current year would risk tipping sentiment too far given the headwinds the economy already faces, namely the peak in the resources capital expenditure cycle and the soft jobs outlook as corporates downsize and China continues to face issues in transitioning its domestic growth model.

Corporate News

In corporate news, Aurora Oil & Gas rose strongly after it received a takeover bid from Baytex Energy Corp of Canada. Aurora's key asset is a stake in the highly prospective Eagle Ford shale oil area in south Texas. Also, one of our holdings in the large cap space, Oil Search, raised funds from the Papua New Guinea Government (equivalent to 10% shareholding) to finance the acquisition of a stake in Elk/Antelope Gas Fields in PNG. It is unclear how these substantial fields will be developed, other than the fact the PNG Government wants them developed in the earliest practical timeframe.

Sector Returns

Returns to 28 Feb 2014	Index %	1 Month	1 Year
Consumer Discretionary	*4.90%*	6.70%	24.20%
Health Care	*4.80%*	2.90%	19.10%
Telecommunications	*5.10%*	1.40%	18.50%
Financial ex-Property	*37.60%*	5.60%	17.50%
Information Technology	*0.90%*	6.30%	9.30%
Utilities	*1.70%*	5.60%	8.50%
Industrials	*6.70%*	3.90%	5.10%
Property Trusts	*6.10%*	4.30%	3.90%
Consumer Staples	*8.10%*	4.60%	3.60%
Energy	*5.90%*	5.70%	2.20%
Materials	*18.20%*	4.90%	-0.30%

The Best of the Month

The best performing sector during February was Consumer Discretionary, which rose 6.0%. The Media segment delivered a strong return of 7.4% supported by Newscorp (+9.8%), which announced a better than expected maiden result (after the demerger from FOX).

The other strongly performing sector was Information Technology, which gained 5.7%. Computershare rose 6.3% after announcing a strong result that showed solid cost control, and a better than expected outlook.

The Worst of the Month

The worst performing sector was Telecommunications, which declined 1.2% for the month, excluding dividends. Telstra rose 1.1% for the month, delivering a sound result and announcing an increase in the interim dividend to $0.145 (v $0.14 in the pcp).

The Healthcare sector also performed poorly during February, rising by only 2.5%. Sonic gained 6.8% after delivering a solid result buoyed by a decline in the currency and lower interest expense.

Economic News

Key Indicators	31-Jan-14	28-Feb-14	Change
$AUD	US0.88	US0.89	↑
Oil (crude)	US$97bbl	US$103bbl	↑
Gold	US$1,245/oz	US$1,326/oz	↑
RBA Cash Rate	2.50%	2.50%	-
Aust 10yr bond	4.00%	4.02%	↑
US T-bills	0.14%	0.14%	-
US 10yr bond	2.64%	2.65%	↑

Market Outlook

The Australian equity market's strong rally in February was partly driven by a recovery from the January sell-off, but also by a more positive reporting season than had been expected. This month we will take a look at the key themes emerging this reporting season and how the different segments of the market faired. This is important as last year the market was driven predominantly by PE expansion. For the market to continue to move higher, as we currently expect, we do need to see EPS growth coming through in fiscal year 2014 and 2015.

Key Themes:

1. Productivity improvement:

We saw a number of companies begin to deliver productivity improvements (or internal self-help strategies) that assisted in driving EPS. What is productivity improvement? People often associate it with reducing head count, and this receives a lot of media attention (e.g. Qantas). However, often it is actually about changing the way business is done, for instance to take advantage of the benefits of new technology or changing customer preferences. It can also be about doing more with the same fixed asset base. The US corporate sector has been implementing productivity improvements at a much quicker pace than their Australian counterparts, and this has allowed them to achieve EPS growth over the past 5 years in the face of a pretty poor economic environment.

We expect productivity improvement to be a feature of the Australian landscape for a number of years to come. Whilst some of the gains may be lost due to competitive pressures, we expect the duopoly/oligopoly nature of many industry structures means some of the benefit will be retained. For instance, BHP beat expectations after delivering a solid 1H14 financial result driven by across-the-board productivity improvements. Andrew MacKenzie (CEO) indicated his management team are focused on embedding the productivity culture into the organisation. Part of the focus is on reducing operating costs that had become bloated during the peak of the commodities boom. In addition, management aims to free up cash to return to shareholders by trimming capital expenditure, and maintain production growth by getting more from existing infrastructure.

There are numerous other examples across the market of companies on this transformational journey. A productivity agenda can greatly lift performance in a lower growth environment. However, what is good for the corporate may not be good news for the broader economy!

2. Currency & interest rate tailwinds

During this reporting season we saw evidence of the translational benefit of the depreciation of the Australian dollar to companies with international operations. These companies have had a drag on earnings over the last few years as they dealt with a run up in the currency from the mid-60's to the US dollar in early 2009 to over parity from late 2010 to mid-2013. Since mid-2013, the Australian dollar has declined about 16% and we expect more to come. There will also be select segments of the domestic economy that will benefit from the lower currency.

The decline in the RBA base interest rate and a tightening of credit spreads after the turmoil of the GFC and the European crisis also provided corporates with a lower quality earnings boost in the last half. While this benefit will eventually unwind, we expect low rates will be with us for some time as the Australian economy deals with declining resources capital expenditure and worsening terms of trade.

3. Revenue growth

Revenue growth improvement in the last half was predominantly driven by a recovery in the resources sector after the soft commodity prices of 2HCY12. The domestic economic cycle is lagging the US recovery, making it harder to drive revenue growth domestically. Headwinds to revenue growth in the domestic economy are likely to remain for some time to come given:

- The maturing resources capital expenditure cycle
- Weak nominal income growth (i.e. as the terms of trade is expected to continue to decline over the next few years)
- The high indebtedness of the household sector, which constrains consumer spending
- The need for the Federal and State governments to repair their balance sheets

An offset for the domestic economy will be provided by the improved competitiveness of a range of sectors thanks to a decline in the Australian dollar. However, this will not be sufficient to fully offset these other domestic headwinds to revenue growth.

Market Sectors

1. Industrials - Global Cyclical

This segment of the market is benefiting from the improving global economic outlook and the translation benefit of the decline in the Australian dollar. This is likely to continue during 2H14.

The developed markets are expected to continue to improve, particularly the US. The emerging markets may provide some headwinds in 2H14 as the US Federal Reserve's tapering of its quantitative easing program continues to cause financial issues for Indonesia, India, Brazil, Russia and Turkey.

2. Industrials - Domestic Cyclical

The domestic housing outlook continues to strengthen and the economy is off its lows for a number of other segments. Productivity improvements have been a key driver of earnings for a range of companies, and should provide them with more leverage to a domestic recovery.

3. Banks

The banks are currently benefiting from the market factoring in cyclical low bad and doubtful debts and a modest recovery in credit growth. Whilst the cycle will turn for bad and doubtful debts, the lead indicators are looking benign and the market is likely to continue to focus on the high yield and improving home mortgage and business credit outlook.

4. Resources

The major diversified miners, BHP and RIO, benefited in February from a better price outlook for their respective key commodities, the lower Australian dollar, and their productivity initiatives. As highlighted above, productivity initiatives are going to be important for both companies in coming years. The focus on debt reduction and limiting capital expenditure should assist medium term commodity pricing (if others behave in a similar manner).

About Ralton Asset Management

Boutique - Value - SMA's

Ralton is a boutique investment manager owned and operated by experienced and passionate investment professionals. Ralton is a highly focused Value manager with a clear investment philosophy and a proven research-driven investment approach that has been developed over many years.

As one of Australia's only managers specialising in separately managed accounts (SMAs), Ralton is able to effectively combine the many benefits of traditional active portfolio management with the best features of direct share ownership. The end result is a highly transparent and tax efficient investment portfolio professionally managed by Ralton.

For Further Information

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