Monthly Newsletter – September 2014

Reporting Season

The reporting season began with one clear aim: **satisfying the shareholder**. As the reporting season came to a close, described by many analysts as **solid,** it had done enough to support existing investor sentiment and with the help of those a little more optimistic, the index pushed to the highest level we have seen in six years. The key themes that emerged during the reporting season were **debt reduction**, **cost cutting** and **divestment from non-core assets**. These were the main drivers behind **growth in net earnings,** reported by the majority of companies. As the market remains fixated on the attractive yield equities have to offer, investors stay content with the current situation, ignoring a number of red flags, including that many companies are finding it **difficult to lift underlying revenue.**

In truth, the lift in earnings, regardless of the method used to achieve the result, has diminished (to a degree) one of our major concerns, the divergence between price and value. The market, ignoring the possible red flags does remain ahead of itself at this current time, but in a low interest rate environment, funds will continue to flow towards its most productive uses and right now that continues to be the stock market. As the old market cliché goes "let the trend be your friend" and remember to remain rational in thought and strategy as the market advances to new highs.

The Argument Against the Current Advance

If you're not a believer in technical analysis, it would be difficult at the very least, to not take notice of the **Bearish Rising Wedge formation**. The uncanny ability of price movements to respect the formation over a 2.5 year period strengthens the case of a potential "swift" breakout at some point in the near term.

As time passes, the patterns significance strengthens as the wedge continues to compress itself into a tighter trading range and market participants continue to adopt their fearless attitude towards risk. During the month of August we saw the fourth failure of a bearish breakout (blue circle) with the VIX (XVI.ASX) itself failing to break upper resistance of its longer term downtrend (corresponding blue circle for the VIX). The result is: The XJO continues its upward trend, but the lack of volume and lower levels of volatility concludes participants remain content with the current state of affairs and any shock to the financial system will be met with a swift movement, but in what direction?

If you believe in the technical indicators, here are some noteworthy statistics that will be of interest to you, all of which lead to a conclusion the next breakout won't be to the upside:

- In 53% of cases, a pullback occurs on the resistance
- In 27% of cases, false breakouts occur
- In only 3% of cases where false bearish breakouts have occurred has the exit from the rising bearish wedge been to the upside, **but perhaps more concerning…**
- In 79% of cases, there is a downward exit

Our View

In a normal interest rate environment and one where current returns could be closely matched by alternative assets, meaning you could easily switch to bonds and deposit rate products etc for similar yield, many investors would have exited the doors at the 5600 mark or earlier. An advantage that has emerged with a dysfunctional market is **time**. As volatility levels decline, it reflects a higher level of shareholder faith, which gives companies the time to address future concerns because shareholders content with the current situation aren't likely to draw any near-term conclusions. Given this, if the red flags can be addressed in good time then the unlikely may happen and against all statistical outcomes we could be looking at that 21% chance of an exit to the upside.

<u>Attrition Warfare in the Iron Ore market</u>

After falling victim to the commodities boom during 2007- 2008 when the Iron Ore spot price hit US$200 tonne, China was determined to shift the market dynamics in their favor from being a price taker to a price maker. As the largest player in the market, they achieved this goal in a relatively impressive short period of time by becoming miners and ore processors in their own right, through local investment in producing mines and through foreign acquisitions to secure their own supply chains. The effect of additional supply naturally led to lower iron ore prices, but the advantage they gained in the short term is now diminishing rather quickly.

The larger producers, BHP, RIO and VALE have effectively declared a “Supply War” against all competitors, determined to wear down their “enemies” to the point of collapse by forcing them into continual losses on their balance sheets (or at least close to it) until they surrender, even if it leads to lower margins for themselves in the short term. The outcome they are betting on will be reduced supply, greater market share and a shift in dynamics, where they regain some advantage in determining price. Only time will tell if this military like strategy is successful but as they continue to flood the markets with record supply of good quality ore, don’t expect the Iron Ore Price to be heading above US$100 tonne anytime soon and this means continued tight margins for AGO ($US85/tonne), IOH ($US79/tonne), BCI ($US70/tonne), MGX ($US84/tonne) and FMG ($US70/tonne) and continued losses for GBG ($US99/tonne).

Performance of Key Indices

Equities	*Close*	*Change (M)*	*Change % (M)*
All Ordinaries	**5624.6**	**+1.5**	**+0.0003%**
S&P/ASX200	**5625.9**	**-7**	**-0.0012%**
Dow Jones (US)	**17098.45**	**+535.15**	**+0.0323%**
NASDAQ	**4580.27**	**+210.5**	**+0.0482%**
S&P500	**2003.37**	**+72.7**	**+0.0377%**
FTSE 100 Index	**6819.75**	**+89.64**	**+0.0133%**
Nikkei 225 (Japan)	**15424.59**	**-196.18**	**-0.0126%**
10-year bond rate (US)	**2.344%**	**-0.00215**	**-0.0841%**

Upcoming RBA Events

Reserve Bank Board Meeting – 2nd September
Address by Glenn Stevens, to committee for Economic Development of Australia – 3rd September
Minutes of the RBA meeting – 16th September

ABS releases March

Retail Trade (July) – 4th September
International Trade in Goods and Services (July) – 4th September
Housing Finance (July) – 9th September
Labour Force (August) – 11th September
Lending Finance (July) – 12th September
Sales of New Motor Vehicles (August) -15th September
Job Vacancies (August) – 25th September

Upcoming US Economic Releases

ISM Manufacturing Index – 2nd September
International Trade (July) – 4th September
US Employment Situation (August) – 5th September
Retail Sales (August) – 12th September
Producer Price Index (August) – 16th September
FOMC Minutes (August) – 17th September
Housing Starts (August) - 18th September
Existing Home Sales (August) – 22nd September
New Home Sales (August) – 24th September
Durable Goods Orders (August) – 25th September
GDP – 26th September
Jobless Claims – Weekly Basis