## A good vintage

Investors generally went into 2013 with an air of optimism that was somewhat stronger than in previous years. Whilst there were still many risks facing markets, there was a growing sense that they could be successfully navigated. Such optimism generally proved well founded and although concerns over central bank policy and the global economic recovery reared their heads from time to time during the year, any resulting weakness was generally well bought. As a result, 2013 will generally be bottled as one of reasonable vintage.

Many markets globally, not least of which the key US indices, reached all-time highs during the year and, as we round out 2013, remain at elevated levels.

In Australia, after a strong 2012, the ASX200 (chart below) has not matched the performance of other markets, but is still up just under 10% percent for the year at this point. In our outlook piece, we set a year-end target for 2013 of 5200 for the ASX200, a level which was met in September. The index went on to a hit a high of 5457 in late October before tailing off in the final two months of the year. The resource sector has remained something of a drag on the benchmark in this regard, but there are some signs as we close out the year that sentiment is getting ready to rebound.

It was the US markets though which led the way, with both the S&P500 and the DOW Jones (chart below) pushing to record highs during 2013. Investor enthusiasm was underpinned by a recovering US and global economy, a buoyant corporate sector, and the 'ever presence' of the Fed and other central banks willing and able to provide stimulatory support.

**Portfolio Strategy**

We continued with a strategy of ramping up portfolio management in 2013, and generally this was to good effect.

We initiated sell or sell half recommendations 23 times in the Fat Prophets Australasian Equities Portfolio during the course of the year, with gains on all but two. On the other side, we also introduced 15 new stocks to the Portfolio.

In addition, the Fat Prophets 'Income Portfolio' continued to generate strong returns, delivering an income yield of 8.1 percent since inception in March 2012**.** What has been even more pleasing has been the 28.7 percent capital growth, far outpacing the 21.5 percent gain in the ASX 200 benchmark index over the same timeframe

**We also continued our quest to provide further enhancements for Members**. We upgraded the Members' area of our website with the aim of providing Members with a superior website experience. Having taken on board feedback from Members, we made some significant changes to the design, navigation structure, layout and visuals within the Members area. Results from our Members' survey suggest that these changes have been well received.

We also sought to build further on other enhancements made to our service in recent years. Our daily email remains a key centerpiece of our communication with Members and a channel by which we seek to provide clarity on our views on macro and micro-economic developments, and the implication for stock markets.

**Our weekly wrap also continues to receive a lot of positive feedback, summarising as it does the best ideas from across the Fat Prophets suite of research products.** The catchy covers have proved popular with Members and we are happy that we are able to showcase these more prominently through the new website.

Performance-wise, we have been content with the year we have had, with our annualised return on the Australian Equities Report lifting to 18.9% at last count (31 October 2013), outperforming the return for the All Ordinaries Accumulation of 8.4% over the same period.

**We are also seeing the benefits of the many new entrants that were introduced to the portfolio last year, with many re-ratings gathering pace in 2013**. The likes of Amcom, Bank of Queensland, James Hardie and Magellan Financial have continued to impress this year. And we will be more than content if the 'new class' of portfolio entrants in 2013 performs to the same degree next year.

Overall again the positive feedback from our annual survey suggests that our efforts to bolster Member returns and deliver a high quality service have generally been well received.

**We are pleased to report that our efforts have been rewarded in the form of an overall B+ grade from Members this year**. We once again thank Members who have taken the time to provide feedback, and we have published a representative selection of comments from each category in this year-end issue.

Back to the markets, it is certainly telling to reflect back on changing attitudes towards (and outcomes in) key market risks at the beginning, during, and at the end of the year. And indeed it may offer some hints as to how markets will react to developments in the major 'event risks' in 2014.

**The US economy**

**We lead with our view and recap on the world's biggest economy, given the follow through implications for other economies and stock markets globally.**

**At the start of the year, we said that we expected the US economy to make further progress in 2013, with sentiment being boosted by positivity on two key fronts – the housing and employment markets**. And this dynamic increasingly played out as the year progressed.

The US property market had of course already been recovering strongly at the start of the year, but it had been coming off a low base, and the steepest downturn since the Great Depression. Given we also expected

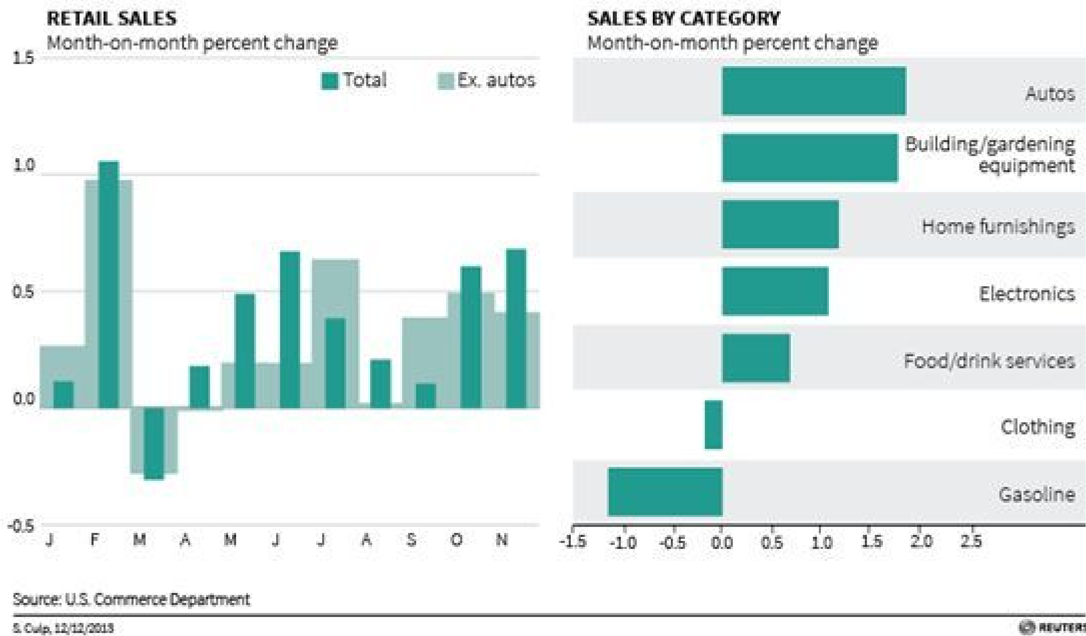
interest rates to remain low, we expected property buying and house price increases to remain strong.

**In the end, the US housing market remained robust in 2013**. Mortgage rates did rise slightly but the second half saw this increasingly brushed aside by homebuyers. The pace of price increases did slow somewhat from a frenetic pace but demand within the housing sector was resilient.

US house price strength was to the benefit of many in the sector, including James Hardie here in Australia. The fibre-cement maker's stock price (chart below) pushed to new highs in 2013, and looks set to benefit from further strength in its core US market.

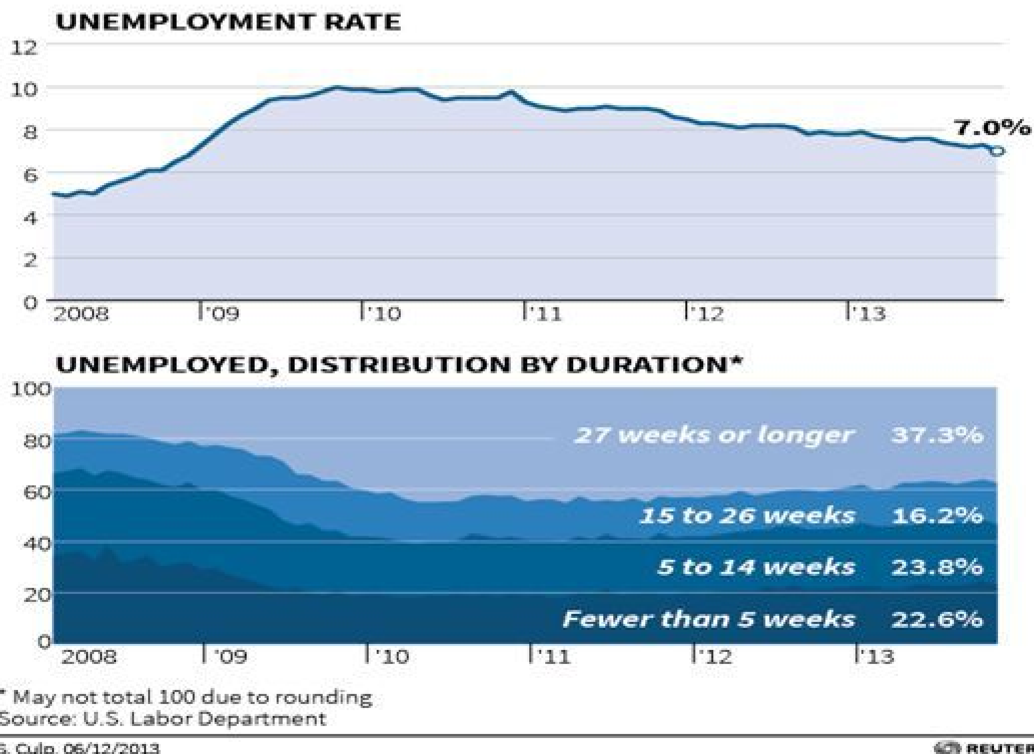
At the start of the year we also talked about improving levels of US home ownership having positive impacts on consumer sentiment, with direct flow on benefits to consumer spending, a key driver of the American economy.

**This also materialised, with the US consumer recovery continuing to gain traction.** The latest evidence here came in the start to the recent shopping season, with November retail sales recording the biggest gain in five months. This is of course good news for the economy, as the consumer is the core engine of growth.

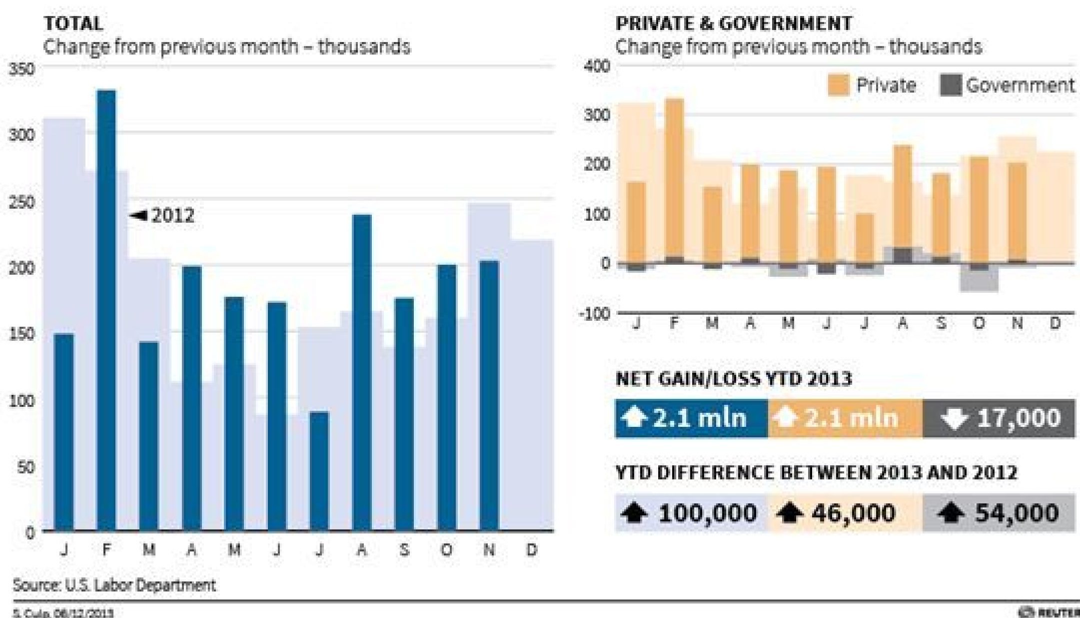



We also said at the start of the year that a recovery in the jobs market would be key to the ongoing renaissance of the US economy in 2013. Certainly, the headline unemployment rate in the US has continued to track lower from elevated levels, although has not yet met the Fed's self-imposed target of 6.5%, a point at which they would consider raising interest rates.

**Indeed, last week we had confirmation that the headline unemployment rate had reached a five year low of 7%.**




It is clear that the stimulus programs embarked upon by the Fed has continued to feed through to confidence and the jobs markets in 2013, with job creation robust, and often ahead of expectations. This was most recently evidenced by the non-farm payrolls number which came in at **203,000 in November and well ahead of forecasts of 180,000.**




We also said at the start of the year that the Fed (and other central banks) would remain supportive with loose monetary and fiscal policies. And, to date, they have not disappointed, with the US and many other

countries committed to a tacit currency war, and afraid of individually refraining from competitive devaluations. Of course, there has been plenty of jawboning otherwise, but actions speak louder than words.

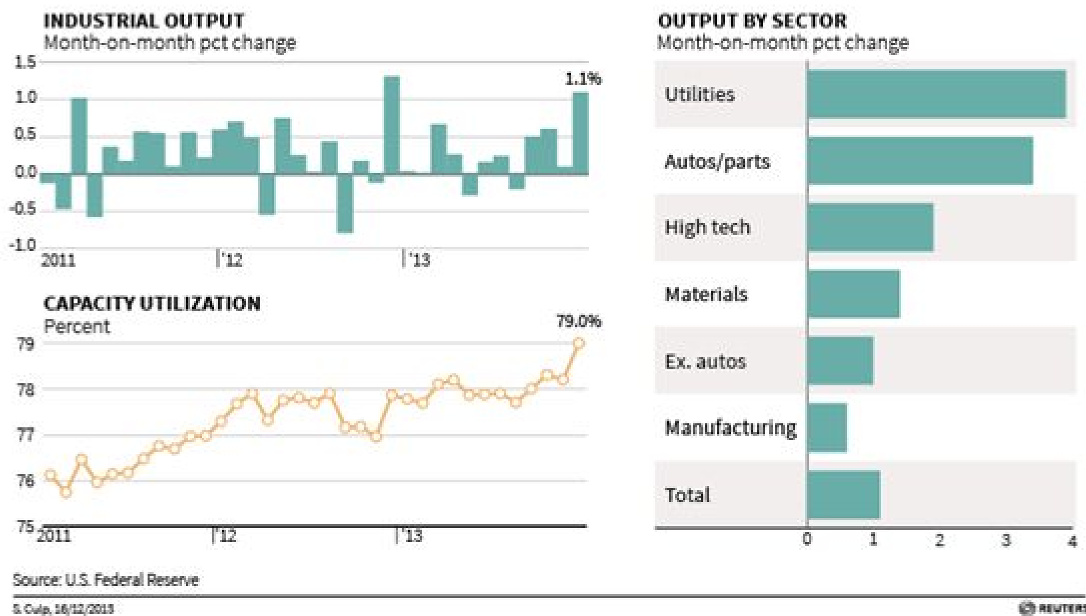
Increasingly robust economic data however led to the great guessing game of when the Fed & Co would start to withdraw stimulus. 'Taper talk' has dominated the last third of the year with speculation that the Fed is about to start pulling back on its stimulus program.

Angst over stimulus withdrawal has seen periodic pullbacks in the markets, but as we write (and with the Fed meeting tomorrow), it has been a case of plenty of talk but no action as far as the taper goes. And in any event, we remain of the view that when the cut does come it will be in form of a 'mini-taper'. This is as the Fed is backed into a corner as far as the negative impact of unleashing high interest rates on an economy which is not quite ready for it.

30 year Treasury yields are now at their highest levels in four year and clearly bond markets are rising in anticipation of the Fed reducing buying and letting the market determine the long end of the curve. Rates are also obviously sensitive to the stronger economic data, but then again the Fed has to be aware of longer term rates, and where they can be allowed to get, and how quickly, to ensure the recovery is not disrupted.

Politically in the US, we started the year with the threat of the fiscal cliff and September saw a budgetary standoff which caused a partial government shutdown. The nuclear option of a US default was ultimately (and predictably) avoided, but served as a reminder of the deeply opposing (and some would say irresponsible) factions within the US political system.

Confidence post the impasse has however quickly recovered, as evident in strong industry numbers coming through, the most recent being a 1.1% jump in industrial production in November.



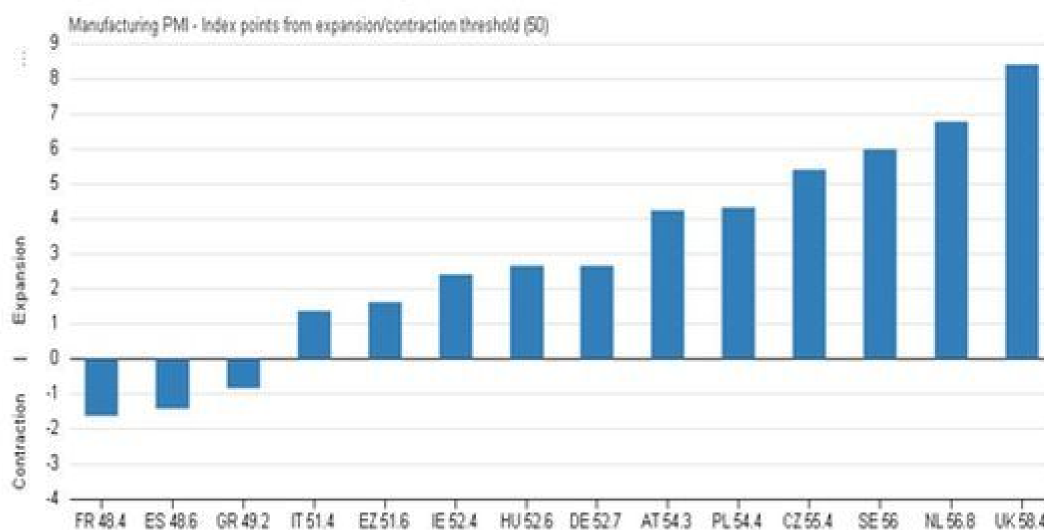

The confidence of corporates meanwhile was also borne out in an increasingly strong earnings picture across the US during 2013. And as we head into 2014, outlook statements remain resoundingly upbeat.

We also saw business confidence manifest itself with an increase in corporate activity during the year. High profiles deals included Vodafone's sale of Verizon, Microsoft's purchase of Nokia's mobile assets, and who could ignore news of Twitter's IPO.

**Europe**

At the start of the year we also talked about the Europe continuing to rise from the ashes in 2013, and this has played out in some measure.

Once consigned to failure by some of the 'perma-bears' at the depths of the GFC, Europe, led by Germany, has continued to push ahead on the economic front. Further confirmation came recently with the release of generally robust PMI manufacturing data on the Continent, the highest since June 2012.




**Europe of course has much further to go before it is fully recovered, with a still elevated unemployment rate for one, but things are moving in the right direction**. It is also interesting that many of the worst 'Euro culprits' of the GFC are also showing clear signs of life. The situation is improving in the likes of Spain and Italy for instance, and Ireland this week became the first EU country to emerge from the bailout.

Meanwhile, as we suggested at the beginning of the year, the UK has pushed on further in its recovery and independently to some degree of that in Europe. This is somewhat ironic given some of the naysayers' forecasts for the UK at the start of the year. Britain has clearly benefitted from being in control of its own monetary policy, although this is likely to remain loose for some time yet. However, the UK should also get another tailwind as Europe itself begins to recover.

The improving situation in Europe meanwhile has not surprisingly been factored in by investors, with many bourses (including the DAX below) in the bloc pushing to multi-year if not all time highs.

**Japan**

The Japanese market meanwhile was one of the standouts globally with a 20 year bear market continuing to thaw with some gusto. The market has doubled since November last year.

**We flagged the significance of Shinzo Abe's bold monetary plan at the start of 2013, and this was certainly the catalyst for a significant re-rating in Japanese equities during 2013**. Furthermore,

newfound confidence has proven infectious with the recent Tankan survey revealing that Japanese business confidence is now at six year highs.

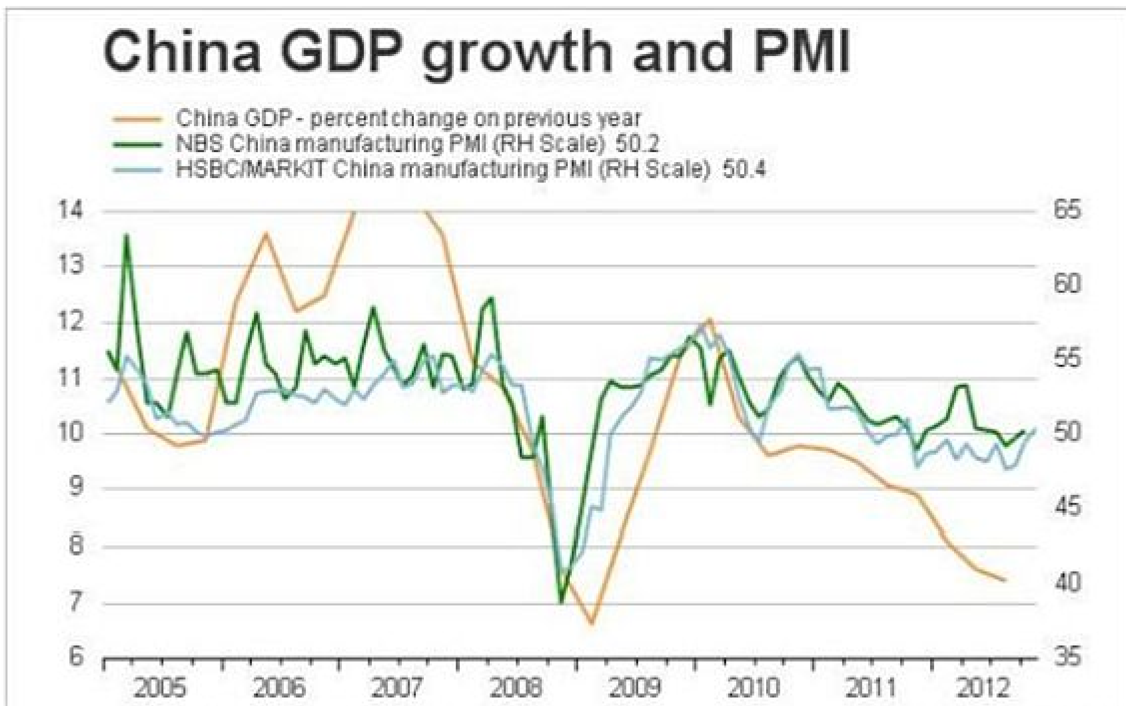
A key driver of competitiveness and confidence continues to be the weaker yen, which has been falling against most of the major currencies, including the US dollar. The prospect of ongoing weakness should only further lift the export sector. Additional structural reforms meanwhile will provide another tailwind to the broader economy.

**China**

A hard landing in China was another 'event' that just didn't happen in 2013. Whilst some data was patchy, there was also plenty of evidence that growth was stabilising at elevated levels.

**Impetus has been provided by the commitment of Chinese policymakers, whom are embarking on a series of major reforms,** including changes to the one child policy, over the coming years. **In our view these reforms could prove to be more powerful than the infrastructure-driven investments that drove the boom last decade**.

Although the central government is keen to shift the world's second largest economy to a more domestic demand-led one in the future, it certainly doesn't hurt that the country still boasts solid export numbers. **Chinese exports grew 5.6 percent year on year in October,** while industrial production jumped by 10.3%.




A return of confidence in the Chinese economy is also starting to play out in the Chinese stock market, which has moved out of lockstep with others in recent years. And there are signs that the Chinese stock market (chart of the SCOMP below) is about to break out to the upside. We will draw more upon the implications of this in our outlook piece at the start of the New Year. 4

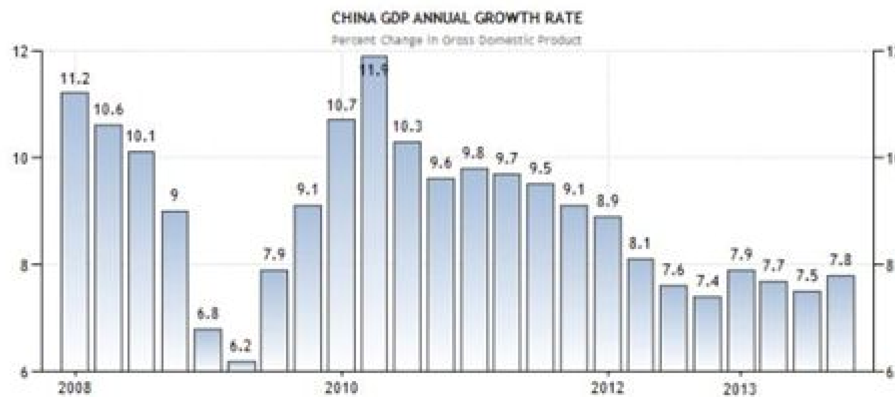
**Resource Sector**

<u>Whilst many sectors have pushed ahead in 2013, the resource sector has remained something of a poor cousin.</u>

Commodity prices have generally remained weak for much of 2013, with the threat of tapering it seeming to have had a pronounced impact on sentiment.

**This of course has had a significant impact on the resource-heavy Australian market, with particular pain felt at the junior end.** Pervading negative sentiment and an inability to raise capital have seen a number of casualties in the small cap arena, compounding a general air of capitulation.

The momentum of Chinese economic growth appeared to have turned as 2013 kicked into gear. Markets and especially commodities were very heartened when China reported its December quarter 2012 Gross Domestic Product (GDP) growth. The December quarter printed the first quarterly improvement in that country's annualised GDP growth in two years.




Source: Trading Economics

Our big miners in BHP Billiton (BHP) and Rio Tinto (RIO) were the major winners as both, especially RIO, are well exposed to China. This new found optimism in China fed into the big miners' share prices, with both stocks printing 2013 high prices in the month of February.

Unfortunately, China's economic momentum was not sustained as as the year progressed. A familiar pattern returned in China's GDP growth numbers through the middle of the year and, with that, optimism disappeared out of the resources sector. Both BHP and RIO hit price lows in the month of June.

Source: Trading Room

A milder loss of momentum in China's GDP growth through the mid year, and its return to positive momentum in the September quarter drove BHP's and RIO's share prices up from their lows.

Going into the end of the year, the big miners' share prices will likely, on a capital return basis, print a small capital loss, or perhaps breakeven, compared to their 2013 start points. Confidence in the clarity of direction in the Chinese economy and the other major global economies in 2014 remains tempered.

The junior miners have done it even tougher in 2013, with little respite from the selling pressure on share prices. We believe there has been a break in the traditional value cycle for junior mining companies which, in turn, is impacting negatively on share prices.

The traditional model for junior miners revolves around raising funds to deliver future in ground value, through discovery, then development and finally production. This cycle should overtime lift share prices as production approaches and returns to shareholders from operations and self funded expansion becomes more apparent.

Source: Fat Prophets

We believe the traditional in ground value cycle is not the current focus of investors when pricing junior miners. Hence, the share prices for many junior miners have continued to struggle throughout 2013.

Investor focus, especially when looking at junior miners, is currently on capital costs to get to extraction, and the dilution of value that every capital raising brings about.

Source: Fat Prophets

The change in the pricing approach to junior miners has come about as the clarity surrounding rising commodity prices has been severely clouded. The lingering effects of the global financial crisis and all its subsequent ramifications dealt commodities a pricing blow; a crisis that had its roots in 2007.

In 2013, the major mining houses share prices have struggled, as weak commodity prices crimped profits and valuations. Cash flows and balance sheets, although winged, have remained capable of supporting future growth, so the share prices march on with perhaps a limp at the moment. For junior miners, the financial equation in 2013 was as dire, but cash flows and balance sheets are not as supportive; so share prices have reacted accordingly.

The value break is the reason we focussed on the big mining houses in terms of buy recommendations in 2013 and have brought no new junior miners into the portfolio this year. We are monitoring the mood of the market very closely, but expect the early part of 2014 to herald no major shift in investor "psyche."

Encouragingly, there are signs that commodity prices are starting to respond to robust economic data. Copper, which is one of the most important base metals used in global manufacturing, is now back at 12 month highs. And as noted in our daily today, 'the multi-year corrective phase that commenced in 2010 now appears to be concluding and this could be an important precursor to stronger price action for the depressed resources sector'.

Thus whilst 2013 has not generally been a positive one, there are possibly signs of better times ahead for resource stocks.

This will particularly be the case if the global economy begins to perform in sync, with a recovering Europe, US and Japan, making a contribution to demand and taking pressure off China.

**Gold**

The gold price is set to endure its first significant negative return in years, as the price pushes towards its low for the year. The gold price appears certain to close the year out toward the bottom of our mid-year revision price range of US$1,250 an ounce. At this price level, gold will have returned a whopping negative 25% for the year.

Gold has had a very challenging year in 2013, with sentiment currently extremely poor towards the sector.

Whilst we have hit the mark with many of our thematic calls from the start of the year, the gold sector has not played out as we thought. We recognised this fairly early in the year and restricted our exposures, confining our recommendations to producers we believed would do well over the medium to longer term as gold prices recover.

Under-performance in the gold price throughout the year appears to lay in the rhetoric, but not any action by the Federal Reserve, to commence tapering its US$85 billion per month bond and mortgage buying initiatives.

The signalling, by Members of the Fed, that tapering of quantitative easing initiatives was being considered, as US economic data showed signs of improving, albeit mildly, delivered a massive blow to gold based exchange traded funds.

During the latter stages of the gold price rally, investment money was pouring into ETF gold funds. The requirement for these vehicles to purchase physical gold to support the fresh investment inflows had a major upward impact on the gold price.

**In our view, the exodus of investors from financial vehicles such as ETFs has been a key factor in the slide of the gold bullion price this year**. In the second quarter of the year, there was a 402.2 tonne outflow from investment in ETFs and similar products, bringing the total for the first six months to approximately 650 tonnes of outflow. On a positive note, the outflow from ETFs slowed in the third quarter to about 119 tonnes.

Meanwhile, consumer demand is actually still rising, but only partially able to offset outflows in investment demand via ETFs, and the geographical flow of gold from western to eastern markets. Consumer demand for gold in the forms of gold jewellery, bars and coins for the first nine months of the year was a record level of 2,896 tonnes, well above (+26%) the levels seen in the first nine months of 2012.

However overall, demand for gold has been weak. In the third quarter of 2013 gold demand was 868.5 tonnes, or about US$37 billion. This represented a year on year contraction of about 21 percent in terms of tonnage demand.

Source: Thomson Reuters GFMS, World Gold Council Gold Demand Trends Q3 2013

Although gold bears have prevailed this year, we continue to believe that gold is in a secular bull market. Central banks continue to print money and, despite much chatter, we have not seen disengagement from these policies around the globe. Yes, we may see a taper from the Fed, or some version of it implemented in

2014, which could be the final trigger for the bottom in gold bullion prices in this cycle, but we believe the Fed and other major financial authorities will be reluctant to move aggressively to reign in liquidity.

It is therefore possible that there is some respite on the horizon for the beleaguered gold sector.

**Elections, the Australian economy, and the RBA**

Whilst perhaps not matching the shenanigans in Washington in September, 2013 saw plenty of drama on the Australian political landscape. Julia Gillard, after surviving a leadership challenge earlier in the year, was toppled by Kevin Rudd in June. His stay at the helm however was relatively short-lived with Labor dumped in the Federal election in September and Tony Abbott taking over as PM.

Proceedings were however somewhat less dramatic over at the Reserve Bank of Australia. **We said in our outlook statement at the start of the year that the RBA would continue with an easing bias in 2013 and so it has proven with two rate cuts in the calendar year, taking the benchmark rate from 3 to 2.5%.**

We expected this easing bias to of course relieve tension on the elevated levels in the Australian dollar, and this has been the case with the currency falling around 12 percent this year.

**The move will of course provide welcome respite for companies impacted by the Australian dollar.** The tourism industry should particularly benefit from a weaker dollar and in line with this prospect we added leisure parks operator Ardent Leisure, and gold coast property developer Sunland to the portfolios in 2013 (these also complemented our existing exposure to the region through the Bank of Queensland). Given our expectations of further easing by the RBA and consequent weakness in the Australian dollar, we expect both will continue to enjoy an increasingly favourable environment.

For some industries, however, dollar weakness has come too late, as evidenced by the announcement of automakers Ford and Holden that they are ceasing their manufacturing operations in Australia.

The RBA of course has to balance the economic gains from further rate cuts with a rising housing market (average prices in the largest Australian cities were up 8% in November to $606,003 according to the RP Data-Rismark home value index), but the odds look to be on that a weaker Aussie dollar will continue to be targeted as a means of boosting the economy. This is also as the recovery in the labour market here remains relatively tepid.

And economic growth is not exactly firing just yet. Mainly on the basis of weaker than previously expected mining investments, the RBA has cut its economic growth expectations for fiscal 2014 and 2015 by 0.5 percent to 2-3 percent and 2.25-3.25 percent, respectively. The surprisingly dovish statement (at least to the market), coupled with the currency situation, certainly provide **further support to our consistently-held view that at least one rate cut is on the cards in the early part of next year**.

**Volatility absent again**

Perhaps it was no surprise that overall market volatility fell back this year, although there were still plenty of risks out there to make investors nervous. And particularly so, if you listened to the dire warnings from the likes of Nouriel Roubini whose negative views refused to go away in 2013.

**However a chart of the volatility index below reaffirms just why the bears were shedding tears in 2013.**

The VIX peak in the end was seen in January in the lead-up to the non-event that was the US fiscal cliff. The index (as we suggested) continued to track down during the year, the journey only briefly interrupted by the budgetary impasse and debt ceiling standoff this year, along with periodic concerns over taper talk.

**Stock selection**

Once again we saw a number of opportunities on both the buy side and the sell side this year.

We took the opportunity to exit (or partially exit) a record 23 recommendations in 2013 and these are outlined in a separate piece in this week's report.

On the buy side, we added several high quality companies that we believe were being ignored by the market. Included in the list are the likes of My Net Fone, Donaco International and Ardent Leisure. There were some disappointments that have not performed to date, including QBE Insurance, although we continue to believe that the medium to long term value story in each case remains in place at this juncture.

**On reflection 2013 will generally be remembered as a vintage year for stock markets, and one in which key market risks failed to eventuate.** This rewarded investors who stayed the course amidst periods of volatility, and meant that the bears were once again shedding tears.

Big picture risks have not gone away completely of course and we believe astute portfolio management will remain just as important as we head into 2014. We of course remain committed to seeking out excellent investment opportunities for Members again next year.

We discuss where we believe the opportunities will potentially lie in our 2014 Outlook piece in our next report on the 7th January. We will also produce our views on the Top Themes for 2014, and expect a few surprises here again.

Closing off on 2013, we would like to thank all Members for their continued support, and wish all a happy and safe Christmas and a prosperous New Year.

Best regards,

**Fat Prophets**

Disclosure: The following stocks are held in the Fat Prophets Concentrated Australian Share Model; Amcom, BHP, Bank of Queensland, Carsales.com, Evolution, James Hardie, Magellan Financial, My Net Fone, QBE, Rio, Sunland, Telstra. The following stocks are held in the Fat Prophets Mining and Resources Model; BHP, Evolution, Rio. The following stocks are held in the Fat Prophets Global Opportunities Model; QBE. The following stocks are held in the Fat Prophets Australian Share Income Model; Amcom, Bank of Queensland, QBE, Telstra. The following stocks are held in the Fat Prophets Small and Mid Cap Model; Amcom,Bank of Queensland, Carsales.com, James Hardie, Magellan Financial, My Net Fone, Sunland.

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