fatPROPHETS™ 1300 881 177

2014 Review 16/12/2014 **FAT-AUS-703**

The Tribe has Spoken

Investors approached 2014 in a fairly upbeat fashion, with many market risks dissipating, although conscious that others remained ever present. As it turned out the year saw the return of geo-political risks with some vigor, with Russia's attack on the Ukraine, tensions also reheating in the Middle East, and yesterday's sad hostage situation in Sydney.

As it has turned out Russia's actions have come full circle with sanctions, along with a falling oil price, leading to the collapse of the country's currency. This has also impacted global market sentiment generally. On the economic side, and over the course of the year, Europe was back on the table as an issue that will not go away, with not only the peripheries in focus, but the Eurozone creaking at the centre with cracks appearing in Germany.

Central banks therefore were (and still are) the centre of attention despite being at varied stages of their stimulus plans. In the US, increasingly positive data from the economy vindicated the Fed's easy money program, and questions over when this would end, was a constant question. On the other side of the Atlantic the bigger question was when would the ECB press the button on full scale QE with investors kept guessing as the year draws to a close.

While doubts meanwhile remained over a hard or soft landing in China, one thing which was not in doubt was the commitment of the government and central bank to stabilise growth at still-high levels. **As the penny continues to drop here for investors China has been one of the best performing markets in the second half of 2014, and has left a six year bear market in its wake.**

Also performing robustly has been the Japanese stock market with Shinzo Abe continuing with his bold monetary plan, and the consequent yen weakness stimulating investor confidence. This has been given a further fillip by Abe's commanding election win over the weekend.

With major economies at different stages of their recoveries, and central banks at varying junctures in their stimulus programs the performance of global markets was fairly disparate. Whilst US markets pushed steadily onto new record highs for much of the year, others, including Australia and the UK waned, weighed down by resource exposure in particular. China and Japan meanwhile turned in robust efforts, and reversed protracted periods of underperformance somewhat comprehensively.

As we round out the year it is telling to see that markets in China, and Japan remain around multi-year highs (despite some selling the past two days). These countries will have a large say in the overall global economic picture in 2015, and investor confidence here is a positive sign. US markets meanwhile also are only (following the recent pullback) around 4 percent down from their record highs, and are also a leading indicator of the strength of the world's largest economy.

In Australia, the ASX200 (chart below) performed solidly in the first two thirds of the year but fell away after that as weak commodity prices, a faltering economy, and concerns over the Murray inquiry sapped investor appetite. The market as a result underperformed many other global indices with the ASX currently around 3 percent lower for the year.

In our outlook piece, we set a year-end target for 2014 of 6000 for the ASX200, a level which the index did not get close to during the course of the year. The index reached a high of 5679 in late August before falling away for the remainder of the year.

The resource sector has continued to remain something of a drag on the benchmark in this regard, with key commodity prices such as iron ore being under pressure in the closing months, and a sell-off in oil compounding matters.

Prices in commodities and associated stocks however look oversold as we head into 2015, with some support also set to kick in from the supply reaction coming in. Meanwhile the prospect of the RBA leaning more towards a rate cut could provide a spurt for the broader economy, which is already starting to see some benefit from a weaker AUD.

Portfolio Strategy

We continued with a strategy of ramping up portfolio management in 2014, and generally this worked out well.

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 18 occasions. All but one of the stocks exited are now markedly lower than our exit price.

On the other side, we also introduced 14 new stocks to the Portfolio.

In addition, the Fat Prophets 'Income Portfolio' continued to generate strong returns, delivering an income yield of 10.6 percent since inception in March 2012. Even more pleasing (to our last update at 14th October) has been the 23.2 percent in capital growth, far outstripping the 18.7 percent gain in the ASX 200 benchmark index over the same timeframe

Comments from our Member survey also shows that the enhancements we have introduced in recent times have been well appreciated**. These include a new website which has seen some significant changes to the design, navigation, layout and visuals within the Members area.**

We also looked to build further on other enhancements made to our service in recent years. Our daily email remains a central part of our communication with Members and a means by which we provide clarity on our views on macro and micro-economic developments, and the implication for stock markets, in a timely manner.

Member feedback has also been positive towards our weekly wrap which summarises the best ideas from across the Fat Prophets suite of research products. We also put a lot of thought into our covers, and are grateful for the positive feedback here.

This year we added a further major enhancement in the form of weekly research webinars. These sessions give Members the chance to hear straight from our Head of Research Greg Smith, on our view on market events and developments. The forum style with a Q&A session at the end has also been a great way for us to engage with Members and the feedback here has also been very positive.

Performance-wise, we have been content with the year we have had, with the (independently reviewed) annualised return on the Australian Equities Report coming in at 18.4% at last count (30 June 2014), outperforming the return for the All Ordinaries Accumulation of 8.15% over the same period.

We are also seeing the benefits of the many new entrants that were introduced to the portfolio over the last two years, with many re-ratings gathering pace.

The likes of Amcom, MyNetFone and Magellan Financial have continued to impress this year. We were also able to take profits on other recommendations in pretty quick time, including Vietnam casino play Donaco International.

Blue chip recommendations such as Spark New Zealand and Qantas have also performed well and balanced some of the higher risk disappointments such as Titan and Santos.

We will be looking to improve further in 2015, but will also be comfortable if the new wave of portfolio entrants in 2014 perform to the same or better 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 'A-' 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 has certainly been a mixed one this year, with some indices (such as the US) pushing on with some gusto before pulling back while others underperformed at the start of the year, only to surge ahead in the final furlongs (China and Japan). Meanwhile Australia, Europe and the UK are ending the year at or below where they began with a few questions yet to be answered about the key determinants of market direction.

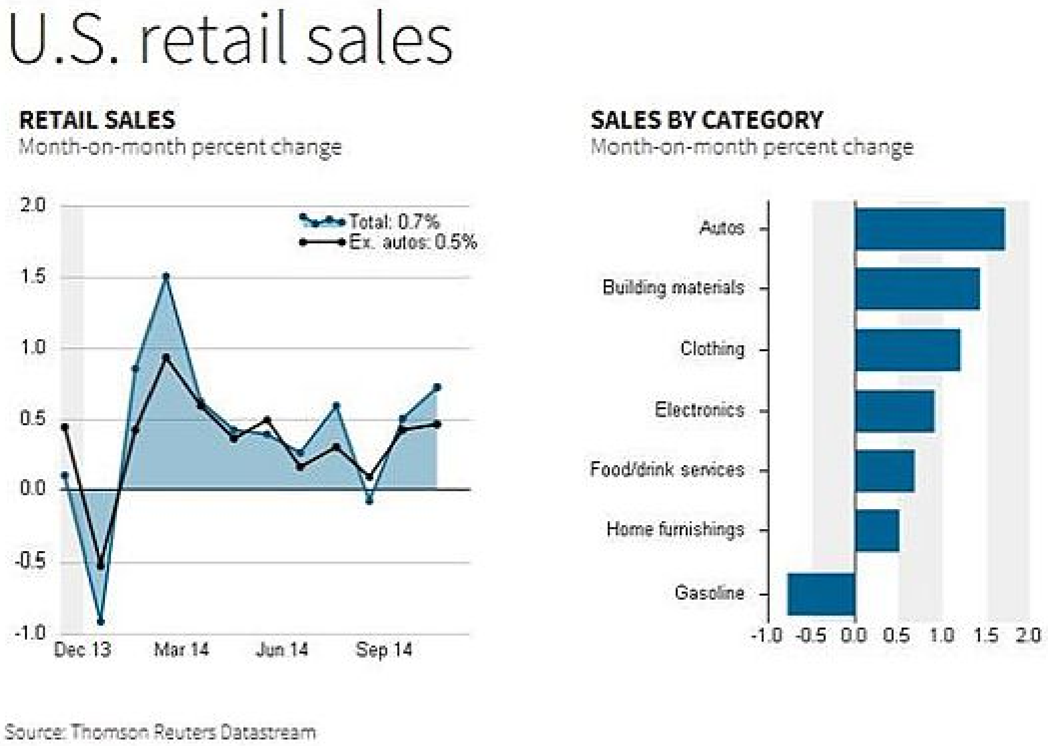
The US economy

We kick off our recap on the world's biggest economy, which still holds great sway for other economies and stock markets globally.

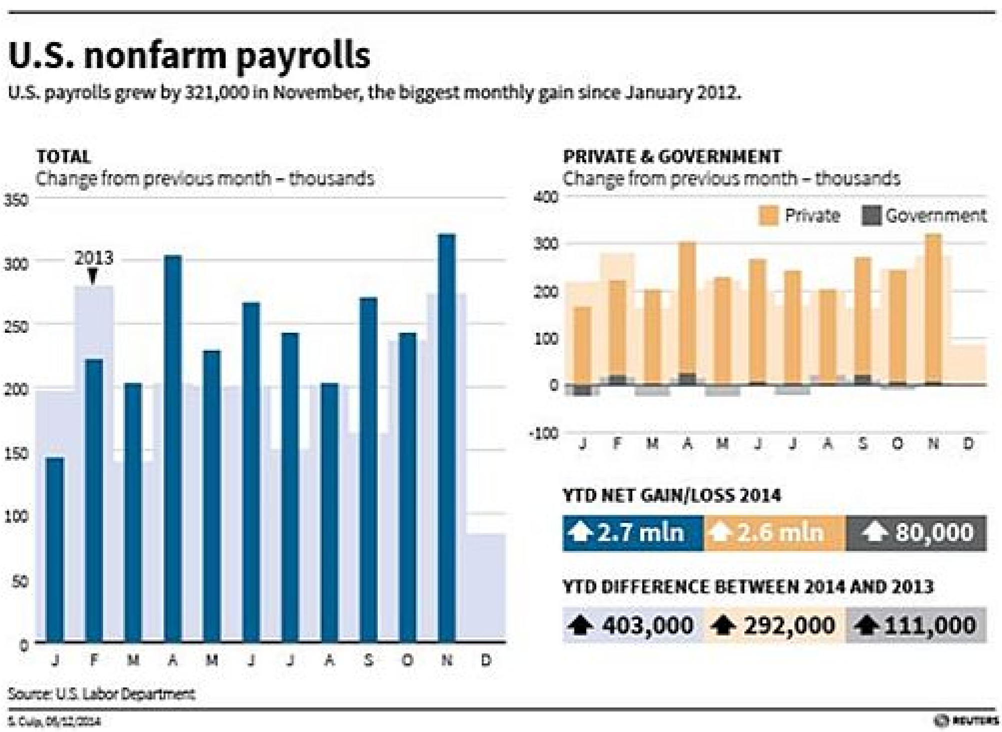
The US markets led the way for much of the year, with both the S&P500 and the DOW Jones (chart below) pushing to record highs during 2014. Investor appetite was driven by a resurgent US economy, strong results from the corporate sector, M&A activity, and a Fed which continued to err on the side of caution as it related to withdrawing stimulus. US markets have pulled back in recent weeks, but this is not surprising given the run seen, and also the elevated valuations (around 17 times forward earnings) versus other markets.

At the start of this year, we said that we expected the US economy to continue making progress in 2014, with sentiment also being boosted by the tacit support of the Fed. We talked about the prospect of a correction, but another upward leg in global economic growth, increasingly positive corporate results, along with more M&A activity, would support stock prices.

In the end the year played out along similar lines. We certainly saw the US economy starting to grind higher, propelled at the heart by an increasingly confident (although sometimes fickle) consumer, underlined by recent strong retail sales numbers. This is of course positive for the economy, with the consumer the core engine of GDP growth in the US.



Consumer confidence was also boosted by ongoing strength in two key areas of the economy – the employment and the housing markets.



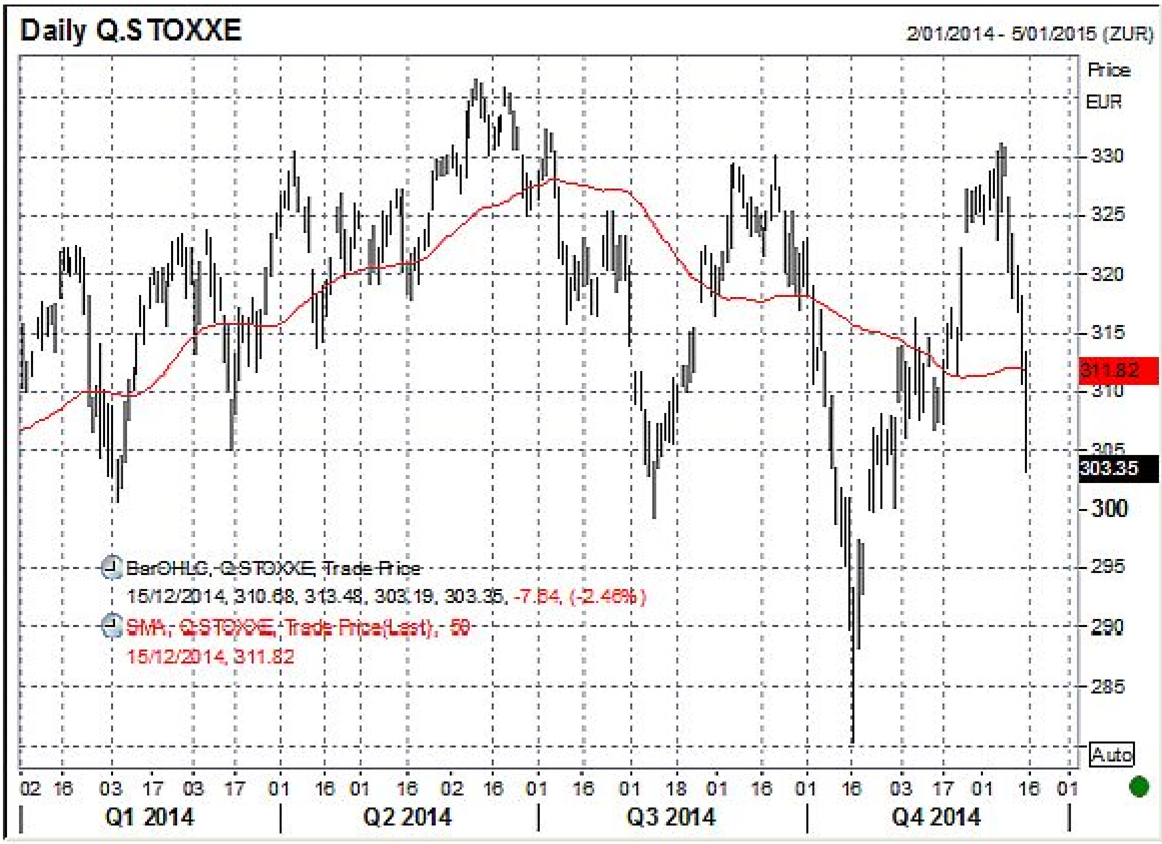
However our suggestions that the Fed would not pull the rug out and start targeting other metrics such as inflation proved well founded. Whilst the tapering of bond buying did play out, interest rates remained at historic lows for the course of **2014. This is certainly not surprising given the Fed is concerned about the potentially damaging consequences of further strength in the US dollar whilst other countries are busily devaluing their currencies.**

The confidence of corporates meanwhile continued to be borne out in an increasingly strong earnings picture across the US during 2014. Margins will also have been boosted further (outside of the energy sector) by the recent weakness in the oil price.

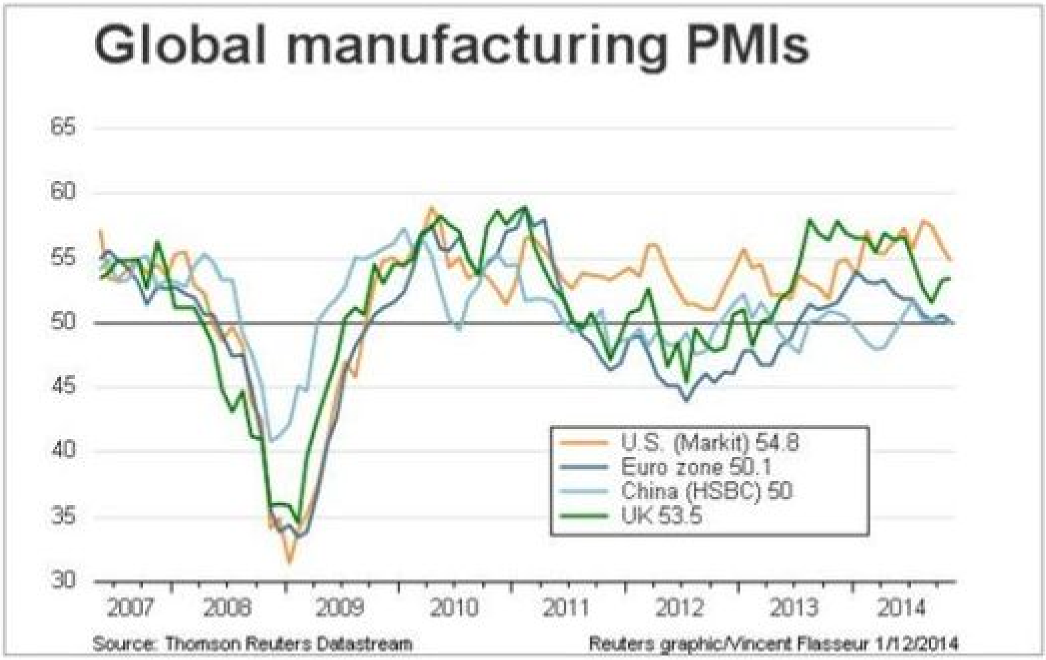
We also saw business confidence continue to manifest itself with an increase in corporate activity and 2014 proving a banner year here. The year kicked off with Suntory's US$13.6 billion bid for Jim Beam and Charter's US$61.3 billion offer for Time Warner Cable. There were also a few that 'got away' including Pfizer's failed $116bn takeover of AstraZeneca and 21st Century Fox's bid for Time Warner. Activity has been a reflection of improving confidence in the outlook and high levels of cash, and a catch cry of 'buy or be bought' was not too far from the mark.

Europe

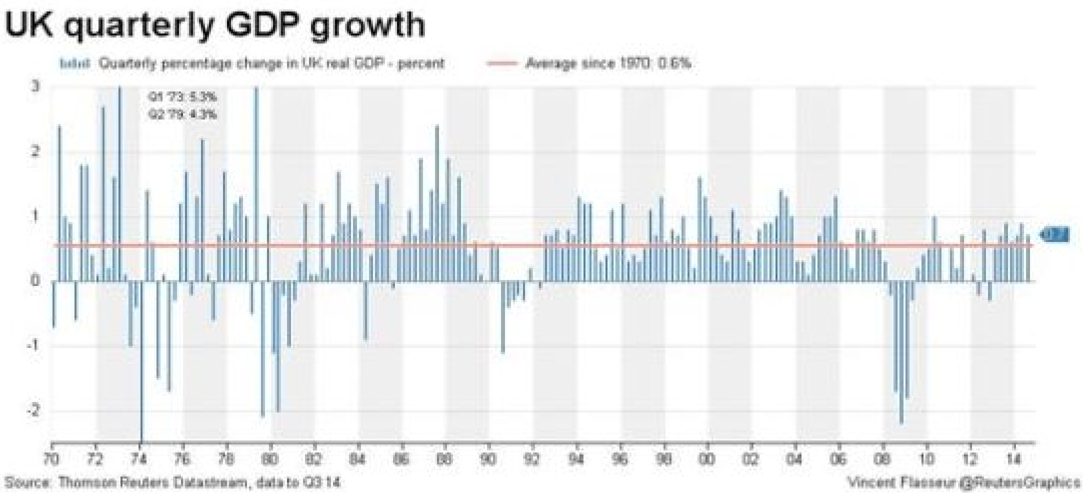
At the start of the year we also talked about Europe beginning to muster strength as the peripheral Eurozone economies emerged from their economic troughs. **The signs for much of the year were positive**, however some blows to economic and investor confidence came via Russia's incursion into Ukraine, and renewed concerns over the banking sector in Portugal in particular. More recently Greece and Russia have appeared back on the radar with political and currency stability issues coming into the frame, whilst volatility in the oil price has been weighing on the energy sector.



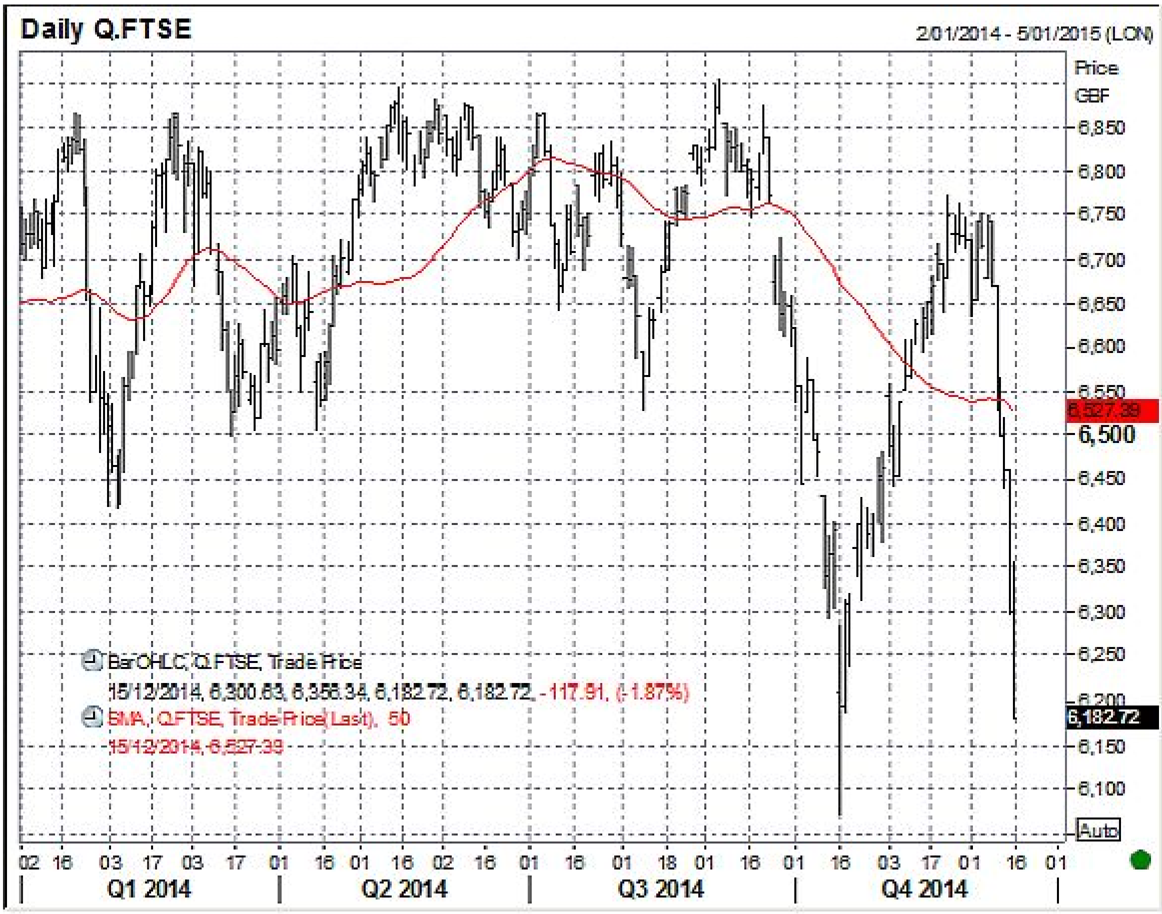
Against this backdrop the key reality has been that whilst the European economy is improving, the rate of gains have been sluggish. This has continued to put the spotlight back onto the ECB to push the button on full scale quantitative easing. In this regard Germany have been central dissenters but that attitude looks to be thawing given the German economy is also coming under pressure.



Meanwhile, we also stated that the UK economy would continue its powerful recovery and outflank that occurring in many other countries in the West. We suggested this was due to be supported by low interest rates, low inflation and a still accommodative central bank. This has indeed proven the case.



However the tailwind that we had expected from the Eurozone has yet to come through for the simple reason that Europe remains sluggish as outlined above. We also said that the FTSE100 would get through 7000 which has not happened. The index however did go reasonably close, reaching 6904 in early September. The UK stock market has however since headed in the other direction, weighed down by Europe, but also the index's heavy oil and resource exposure.



Japan

A market that did play out as we predicted at the start of the year was Japan, leaving a 20 year bear market in its dust. Enthusiasm for Japanese stocks was supported by Shinzo Abe's bold monetary plan, and associated weakness in the yen. Whilst our bullish target of 18,500 for the Nikkei wasn't quite reached, this appears to be only a whisker away as we enter 2015.

We said that we expected an acceleration in the Bank of Japan's bond buying program to further undermine the yen, with the currency pushing up into the 105/110 region versus the dollar as a result. We believed an ever weakening yen will also continue to boost the prospects of Japan's exporters, whose share prices will continue to be upwardly re-rated in 2014. **This indeed played out, with the yen breaching our downside target**, and hitting 120 versus the US dollar.

We saw 2014 as the year that Japan finally won the war over deflation, and though the battle is not done yet, there is at least some confidence to be gained that **Shinzo Abe will be able to continue his plan into 2015 following last weekend's election win.**

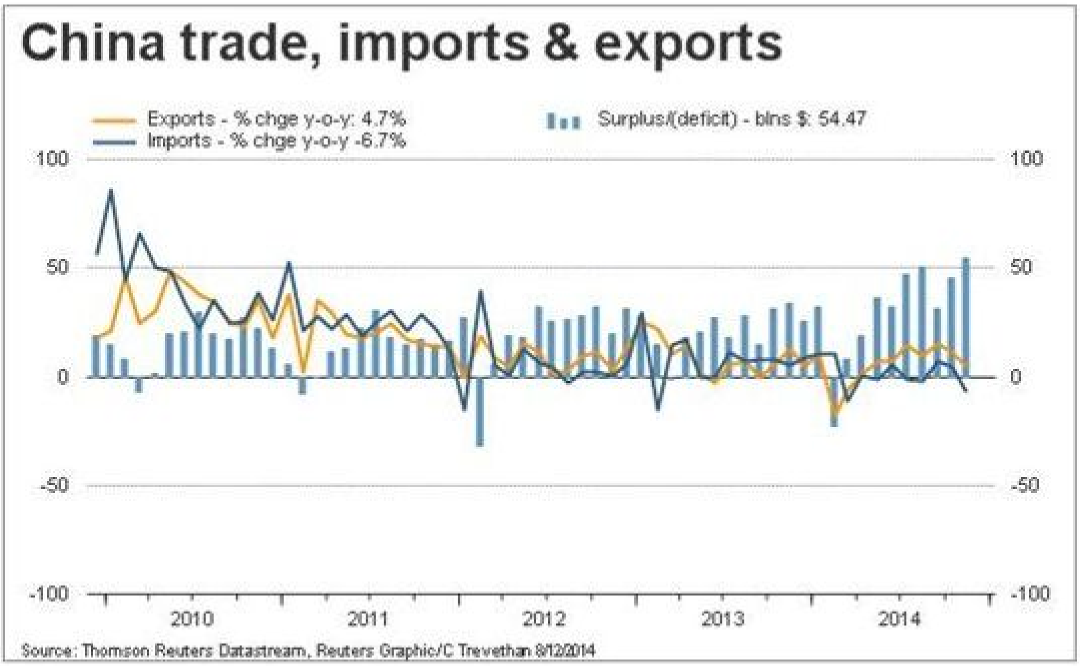
The majority of the Japanese public understand what is needed. They also only have to look over to America, and see what money printing policies have achieved there. And if ever there was a country that was justified in embarking upon a quantitative easing program, it is Japan.

China

Our forecast on China at the start of the year, also proved to be on the money, if not occurring till the second half of 2014. **We said that 2014 will be the year that the Chinese stock markets "Break on through to the Upside"** We believed that Chinese equities could be amongst the best performing equities markets this year. This is as the nation's equity markets make up for significant under-performance over the past six years.

This is indeed what has happened as a range of initiatives being launched by the government set the stage for an impressive market rally, and put the Chinese economy on a firmer footing to a more sustainable growth path for its economy. Our expectation of a secondary lift for the Chinese market coming from freeing up capital flows has also proven accurate following the creation of the Shanghai/Hong Kong market link.

China is not out of the woods yet as far as the stabilisation of growth at high levels goes, as evidenced by recent weak economic data. However what can not be denied is the government and central banks's commitment to ensuring this happens. Having broken the mould on interest rate cuts the authorities look set to push on deeper into their stimulus and reform programs.



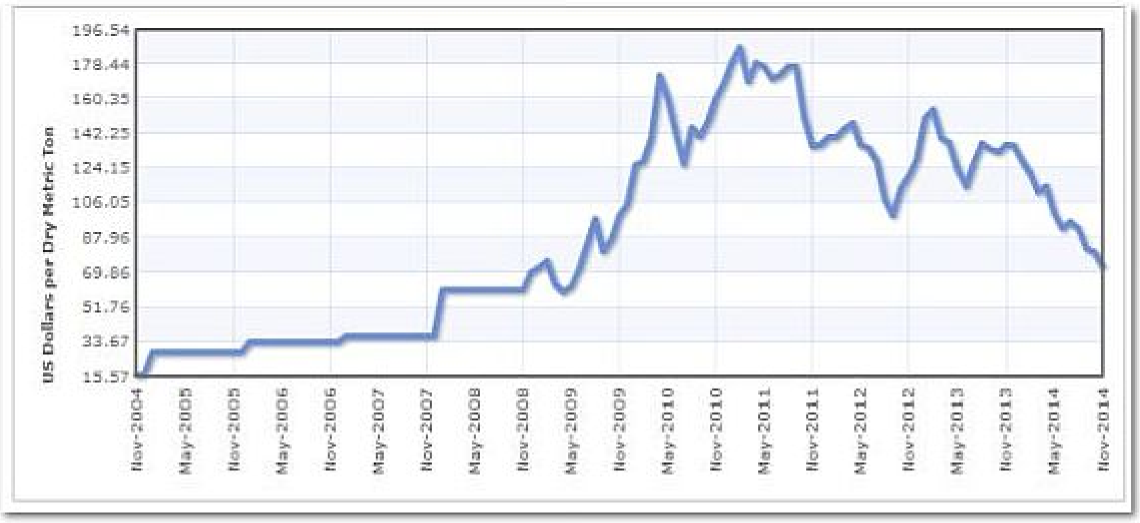
And a stabilisation of Chinese growth at still-high levels would certainly be good for Australia generally and the resource sector specifically. This is as China is a big customer, and ties have been strengthened further by the free trade agreement.

Resource Sector

Despite the fact that sentiment towards China has improved and that country's stock market has been firing, **the resource sector has underperformed in 2014**, with weakness across the board in terms of commodity prices.

The result has been that the share prices of constituents within the mining sector have lost much ground. This point is underlined when looking at the share price of bellwether BHP Billiton which has hit five year lows.

Up until a few weeks ago the metaphor for how weak sentiment towards the resource was could be seen in the iron ore price which has retraced almost 50 percent for the calendar year, to be less than $70 a metric tonne.



Downward price action has been seen as the market has fretted about oversupply, in conjunction with fears that Chinese growth is plateauing. The reality however is that **there will be inevitably be a supply reaction of some degree** with many not immaterial producers uneconomic at current levels. Indeed some of these have already closed their doors (mines).

In the meantime the likes of BHP and RIO remain highly profitable at current levels, and are in a position to ramp up volumes. However they are not necessarily in a position to pick up 'all the slack' currently. It would therefore seem credible that iron prices are at, or at least near, the bottom. The same could likewise be said for the miners in question.

Stealing the limelight from iron Ore in terms of price weakness lately however has been oil with WTI crude falling below $56, also a five year low. Our projection of oil occupying a range of $85 to $110 for 2014 has therefore been well off the mark.

Weakness has also been triggered on the supply side, with OPEC refusing to cut production at their meeting last month. This has opened the trap door on prices.

It will be worth seeing whether OPEC does indeed flinch in upcoming months. Certainly some cartel members are well placed to ride the pressure in the price with high currency reserves, although others are not.

Ultimately (as with iron ore) there will be a supply reaction at some point with uneconomic production being knocked out as the price goes lower. A vast swathe of the new supplies relate to shale, 5 percent of which is now uneconomic at current levels. This would approach 90 percent if we saw oil in the 40's.

Sentiment towards resource stocks therefore at the moment is clearly weak, but we can see a positive reaction coming. On the demand side we are likely to see Chinese growth stabilise at high levels, which can only be a good thing. We are also going to see supply reactions as lower prices bite on high cost producers.

A catalyst for a positive re-rating could come from a variety of areas. It could be Chinese growth, and an associated stabilisation of prices. Also a big corporate deal would certainly help. A suggestion that the likes of **Glencore Xstrata (known for doing deals near the bottom) are looking at Rio Tinto again (and others) has a lot of credence in our view.**

Weakness in the miners has had a significant impact on the resource-heavy Australian market, with particular pain felt at the junior end. Ongoing 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.

However we believe that there are better times ahead for resource stocks. Not least because valuations are low, but also as China stabilises at still-high levels of growth, global GDP generally ticks back up, and as a supply contraction occurs driven by the high cost producers being unprofitable.

Gold

The gold price has also not performed this year, although it may also surprise that it has not fallen off a cliff either. **The precious metal is closing out 2014 around the level it started.**

In our outlook at the start of the year. we said that gold would occupy a range of $1350-$1400 an ounce. This has clearly not happened. We did however suggest that a reawakening of geopolitical tensions would support gold, and **there was indeed a spike as a result of Russia's action in the Ukraine with gold getting to $1390** per ounce. The precious metal has however lost favour since, drifting down throughout the year as the Fed winds down its QE program.

What however has been lost on the market in our view is that there will ultimately be an inflationary outcome from excessive money printing. Also it is worth noting that whilst the Fed is winding down it's program, others such as Europe, Japan and now Russia are potentially just getting started.

We therefore think that the pressure cooker could continue to boil under the gold price next year, particularly if the Fed holds interest rates down, and possibly even returns to QE if the greenback strengthens too much. Gold therefore may yet have its time in the sun again.

The Australian economy, and the RBA

Whilst the RBA did not cut rates as we expected in 2014, the day is getting closer in our view. This is particularly given that many areas of the economy are still struggling, and property hot spots are set to be cooled by macro measures.

It has been noticeable in 2014 that the RBA has gone from trying to 'jawbone' the currency down in general terms, to almost giving specific targets on where they would like the currency to be. This was evident recently when Governor Glenn Stevens talked about being quite comfortable with the AUD at 75 cents versus the greenback.

We expected the AUD to hit a low of 85 cents in 2014, and again it has overshot this target. The move will of course provide welcome respite for companies impacted by a strong Australian dollar.

The tourism industry should particularly benefit from a weaker dollar, with the likes of leisure parks operator Ardent Leisure (which also gets a currency kick through its US business), and gold coast property developer Sunland well positioned. We also added Coca Cola Amatil (after exiting at higher levels in February), Australian Vintage and Elders to the portfolio recently as we believe these companies are also positively leveraged to further weakness in the AUD.

The Financials and the Murray Inquiry

The Murray inquiry has been something that loomed for many months on the bank stocks and in advance of this we took some profits on our portfolio holdings in ANZ, Westpac, and CBA. We however retained a position given our appreciation of the yield appeal and also (while the glory days may be over) forecasting that the recommendations of the financial sector review wouldn't be as bad as feared.

The results have indeed not been as punitive as some thought with a lot pushed onto the regulators. We also believe that the powers that be will not want to squash mortgage lending too much and see a property market correction when the economy is not well prepared for the scenario.

We are also meanwhile encouraged that the playing field may be levelled more for the regional banks and benefit the likes of Suncorp and Bank of Queensland which we hold. These banks should also benefit from their exposure to the Queensland region which should see a kick from the lower AUD.

Media ownership rules

Another hot topic in 2014 was the review of archaic media ownership laws, including the 'reach' rule. This has now been kicked into mid 2015 with some loss of favour for the likes of Prime Media which we added this year.

We still however see the review happening which will bring Prime and others into focus. Ten meanwhile has already been put on the block effectively. This aside though we anticipate a cyclical recovery occurring in the media sector with advertising rates ticking up, which will underpin earnings and share price re-ratings.

Telecoms

The telecoms stocks meanwhile continue to confound those that believe the sector is ex-growth, and opportunities here are limited. Companies such as Amcom (also in a bid situation), MyNetFone, M2, and Telstra all continue to perform well operationally and are doing their bit to optimize shareholder returns. Spark New Zealand also pushed through with a successfull rebranding in 2014 and looks set to go from strength to strength, proving the doubters wrong,

Volatility makes a comeback (but still low in historic terms)

After a fairly quiet first half of the year, volatility has made a mini comeback in the second stanza on the back of European concerns and oil. However it must be pointed out that these headwinds/risks are not insurmountable…indeed far from it. Indeed both are addressable through action of the ECB and OPEC/market supply reactions respectively.

It is therefore worth putting the latest swings in context of the extreme volatility seen during the GFC. Recent moves, though not immaterial, pale in comparison.

Stock selection

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

<u>We took the opportunity to exit (or partially exit) a record 23 recommendations in 2014 and these are outlined in a separate piece in this week's report.</u>

On the buy side, we added 14 companies that we believe were being ignored by the market. Included in the list are the likes of Orora, Prime Media, Scentre Group, and Medibank Private.

There were some disappointments probably the most notable of which was the high risk recommendation of Titan. The recommendation of Santos has also proven mistimed given the sell-off in the oil price, and despite solid fundamentals. We continue to believe that a recovery story in the stocks in which we are underwater remains in place. The outperformers meanwhile have more left in them in our view, including Qantas which is up 80 percent in around 4 months.

On reflection 2014 will generally be remembered as a positive year for many markets, although it was also one in which volatility returned in the latter stages. Resource heavy markets have remained under pressure though which may lower the bar for some outperformance to be seen in 2015.

It was also a year in which out of favour markets such as China returned to the fore. The conditions faced during the year were also ones that reinforced the importance of astute stock and sector selection.,

If the events of Monday are any reminder, risks have not gone away as it relates to the stock market. In addition to geopolitical risks, we are faced with a world where central banks continue to have a great sway in sentiment and economic outcomes. Power brokers also exist in certain sector as evidenced by the recent actions of OPEC.

We continue to believe that astute portfolio management will remain just as important as we head into 2015. We remain as committed as ever to seeking out excellent investment opportunities for Members again next year.

We discuss where we believe the opportunities will potentially lie in our 2015 Outlook piece in our next report on the 6th January. We will also unveil our views on the Top Themes for 2015, along with a few that didn't quite make the cut. Signing off on 2014, we would like to once again thank all Members for their continued support, and wish all a safe and happy Christmas and a prosperous New Year.

Best regards,

Fat Prophets

Disclosure:

The following stocks are held in the Fat Prophets Concentrated Australian Share Portfolio: AMM, ANZ, BHP, BOQ, CBA, MFG, MPL, MTU, QAN, RIO, SDG, SPK, SUN, TEN, TLS, TTN.

The following stocks are held in the Fat Prophets Income Model Portfolio: AMM, ANZ, BOQ, CBAMPL, MTUSDG, SPK, SUN, TLS, WBC.

The following stocks are held in the Fat Prophets Small/Mid-cap Model Portfolio: AMM, BOQ, MFG, MPL, MTU, SDG, SPK, TEN, TTN.

The following stocks are held in the Fat Prophets Mining and Resources Model Portfolio: BHP, RIO.

The following stocks are held in the Fat Prophets Global Portfolio: SPK.

---

associates of the Fat Prophets Group of Companies currently hold positions in: ASX-listed Australian stocks: AAC, AGO, AJA, ALG, AMC, ANZ, APA, APG, AVG, AWC, BCI, BHP, BKN, BOQ, BPT, BRL, BRU, BTR, BWP, CBA, CDD, CFE, CGL, CKF, CNQ, COL, CVO, CZL, DHG, DLS, DNX, DUE, ELD, ENV, EVN, FID, FMG, FPP, GJT, GMG, GOR, GPT, GXL, HUB, IAU, IFL, IGO, ILU, IMF, IPL, JHX, MAI, MFG, MGR, MHI, MML, MMS, MND, NAB, NCM, NEC, NECN, NMG, NUF, OBS, ORE, OSH, OVH, OZL, PAN, POS, PPS, PRG, PXG, QBE, RIO, RXL, RRS, S32, SAR, SDG, SFR, SGP, SHL, SLR, SPK, STO, SUN, SYD, TAM, TLS, TME, TPM, VOC, WBC, WFD, WES, WHC, WOW, WPL, WSA. International stocks: Activision Blizzard, Alibaba Group, Amadeus IT, Apple, Arcos Dorados, Bank of China, Barrick Gold, Baidu, BNP Paribas, BP, Caixabank, China Life Insurance, China Mobile, China Overseas Land & Investment, China Taiping, China Vanke, Cisco Systems, Citigroup, Coeur, Corning Inc., Country Garden, Credit Agricole, Credit Suisse, D.R. Horton, Dai-Ichi Life Holdings, Daikin Industries, Danone, Dr. Reddys Laboratories, ENAV, Euronext, Fanuc, FedEx, Fresnillo, Fukuoka Financial Group, Glanbia, Google (Alphabet), Heidelberg Cement, Heineken, ICICI Bank, Inpex Corporation, James Hardie, KONE Corp., Lennar Corp., LVMH, MGM China, Mitsubishi Corp., Mitsubishi UFJ, Mitsui Fudosan, Mizuho Financial Group, Nintendo, Nippon Telegraph and Telephone, Nissha Printing Co., Nomura Holdings, Panasonic, PICC Property & Casualty, Powerhouse Energy, PPHE Hotel Group, Randgold Resources, Reliance Industries, Resona Holdings, Riverstone, Royal Dutch Shell, Sands China, Societe Generale, Sony Corporation, SPDR Gold Trust ETF, Square Enix, Sumitomo Chemical, Sumitomo Mitsui Financial Group, Tata Motors, TE Connectivity, Telepizza, Tencent, THK Co., Toyota Motor, VanEck Vectors Junior Gold Miners ETF, Volkswagen, Walt Disney, Wynn Macau, Wynn Resorts, XTD, Yaskawa Electric, Zillow. These may change without notice and should not be taken as recommendations.