Switzer Super Report

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Forecasts for 2013

What type of year is 2013 going to be? Are the US and Australian economies improving? And where are stock markets and interest rates headed? In today's note, I look at the predictions of chief equity strategist at Nuveen Asset Management, Bob Doll, and throw in my two cents worth as well.

While we're looking at the outlook for the year, Gavin Madson reveals where he believes fixed income is headed. Don't miss his views. Ron Bewley hones in on the consumer discretionary sector, which is exposed to gambling, retail and media stocks. Are any worth a look? And on the question of the week, Paul Rickard gives his views on WAM and AUI. Have a great day.

Sincerely,

Peter Switzer

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Predictions for the US and Australia 2013

by Peter Switzer

Bob Doll used to be chief equity strategist at BlackRock, the biggest fund manager in the world but now is at Nuveen Asset Management. He has been a legend of the US stock market and his predictions have been closely watched over the years.

Some critics say he hasn't been performing well lately but I relied on him when too many experts were super negative on stocks in 2009 — he even gave me the guts in 2008 to look for the positives that could turn the market around by March 2009.

In fact, I interviewed him, when I took my Sky News Business program to New York in 2010, in the BlackRock boardroom, which had a table as long as a 25-metre swimming pool!

A good year

This is what he predicts for this year and I will throw in my twopence worth as well.

He predicts a new all-time high for the S&P 500 "some time this year", which is only 6% away. I think the US market will do better than this, but there will be some moments when I'll have doubters — I could even doubt it! Or maybe not — but I reckon the Yanks do well and we even do better.

He believes large multinational companies that rely on emerging economies will do well this year. This augurs well for local companies such as BHP and Rio if he's right, and once again, I support his view on up and coming economies. The IMF also believes ASEAN countries will return to pre-GFC growth rates and this means more modernization and that means more steel, which helps coal and iron ore.

Top sectors

On the sectors, he is pro-cyclical and if we see a big year in stocks, which is due, then these sorts of companies are likely to do well. Doll likes Tech companies, industrials and those with positive cash flow to buy stocks and raise dividends.

He thinks banks and financials will do OK, but "won't lead the race" and I think that's a good call for Australia. I'd buy financials on any silly dip or maybe a takeover target.

Improving growth

He expects US and global growth to be better in 2013 and I support this view but importantly, he told CNBC that "the perceptions of growth" will improve so businesses and investors will be more confident about the future of their operation and where P/Es are going, that is up!

This is a big issue for 2013 and we will see this here in Australia as well despite the Treasurer, Wayne Swan, backing away from his surplus promise, which will be good for growth, even with an election year ahead.

Less fear this year

He is arguing there will be a "little less fear in 2013" and we will see things such as more merger and acquisitions (M&A) activity, which not only reflects more confidence but helps share prices.

He is cautious about being too cautious on defensive stocks but that could provide value for the long-term player, who wants dividends more than capital gain, while they'd cop the gain too if it came along.

He thinks dividend increases will be at a double-digit rate, which looks huge for the likes of Telstra here, so I'd rule this one out as a general prediction, but many cyclical companies that have not even paid dividends

lately could easily return dividends this year. I expect better dividends from many companies if the stock prices are rising and economic growth picks up over the year.

On interest rates

Doll also expects long-term interest rates to rise in the USA. In Australia, I think we will see rates fall for home loans, however longer term rates could sneak up, but only slowly, as we get to year's end. For this to happen, we'd need to see a big spike in stocks, which is definitely possible.

Bob Doll might have had some years where he hasn't performed as well as other fund managers and equity strategists but his history is there to look at and as a legend of the stocks game I'm prepared to take his tips, especially when they mirror my own views!

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Outlook for the fixed income in 2013

by Gavin Madson

Given we've entered a new year, it's usual that I'm asked for my view for the coming 12 months, and what investors should be considering with their fixed income investments.

Over the Christmas break, the biggest concern for investors was how the US would deal with the so-called 'fiscal cliff'. While the Congress and the House of Representatives were able to find an agreement of sorts, it fell considerably short of what's probably needed. The final outcome was a removal of the 'Bush tax cuts' for taxpayers earning more than $400,000, but left government spending largely untouched. In fact, a review of government spending was simply pushed back to a later deadline, however the impasse is unlikely to clear in the interim.

Other concerns

More importantly the concerns over the 'fiscal cliff' will be replaced by concerns over the US debt ceiling. In the US, Congress has to approve federal expenditure. Where tax receipts do not exceed expenditures (ie. a deficit budget), the Department of Treasury has to borrow to fill the gap. Under US law, the amount the treasury can borrow is limited by the debt ceiling, which can only be increased by the approval of the Congress.

In 2011, a crisis was created when the Congress refused to increase the debt ceiling as a 'backdoor' way for the Republican controlled Congress to stop, what they viewed, as excessive government spending. The impasse on the increase of the debt ceiling contributed to S&P downgrading the US credit rating from AAA for the first time in its history and the Dow Jones fell 5.6% in one day. Current projections have the US hitting the revised debt ceiling again in mid-February.

So how do I see this playing out?

Like the 'fiscal cliff', the issue will likely be avoided, but not resolved, however, in the interim, indecision, in-fighting and political posturing across the various levels of US legislature will see markets remain volatile, certainly in the first quarter, and likely the first half. With ongoing political paralysis, US companies will be unlikely to unleash their cashed up bank balances, which will be the true stimulus of economic growth and job creation in the US. Companies will remain cautious while this toxic political environment persists.

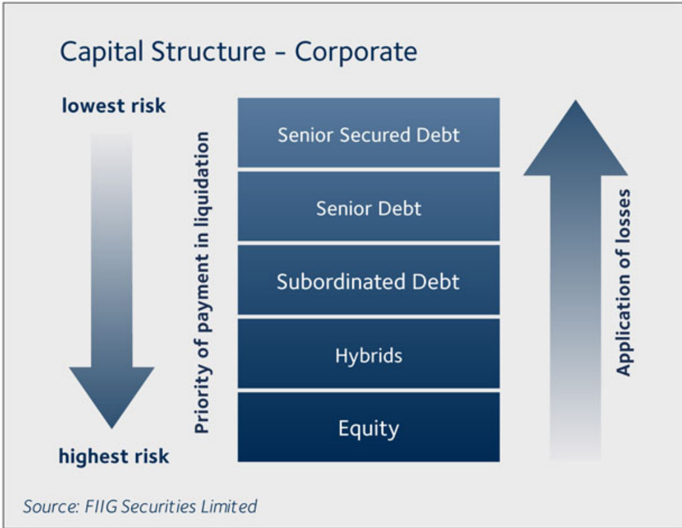
For me, the downside risks in this environment far exceed the upside risks. If the US is able to sort out its issues, then investors can take a more aggressive approach to risk. The opportunity cost of missing an upside pricing 'pop' are small, the downside risk if these issues drag on are more considerable.

So where to invest?

When there's turmoil, safety should be an investor's primary concern. For me, this means heading up the capital structure to the most secure structures – senior secured debt.

To cover short term turmoil, I'd look to secure infrastructure debt, which has a very low risk of capital depreciation. My preferred fixed rate infrastructure exposure currently is the Dampier-Bunbury Gas Pipeline issue, which matures in 2019 and offers investors a yield to maturity of 5.75%, a considerable up-kick from what's available to investors from term deposits currently. This investment grade bond is ranked senior secured over the gas pipeline assets for what is a very basic business model. Gas from the fields around Dampier is fed through a pipeline to the customers in and around Perth. In the current environment, boring is

good, and a gas pipeline is about as boring as it gets.



Source: FIIG Securities Limited

The inflation genie

Beyond the first half of the year, the longer term risks to the economy will likely come from inflation. While currently inflation remains benign, continued stimulatory actions from the RBA (and reserve banks globally) may risk a breakout in the longer term.

The only true protection from inflation in the market are inflation linked bonds (ILBs), and sticking to my gas theme from above, currently there's good value provided from the Envestra 2025 inflation linked bond, which is offering around 395bps above inflation. Given the RBA targets inflation of between 2% and 3%, a long term mid-point inflation assumption would see investors earning 6.45% from a senior secured investment grade bond. If inflation does breakout, the return for investors would be even higher.

Regardless, in my view ILBs should be a part of any investor's self managed super portfolio for the capital protection they provide against the effects of inflation.

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How the listed infrastructure sector is faring

by James Dunn

As interest rates come down, the search for yield intensifies, and one of the sectors most interesting to income-oriented investors is infrastructure. The listed infrastructure sector can be a source of relatively strong and stable income flows, with generally predictable long-term cash flows and earnings.

In theory, infrastructure assets generate a long-term cash flow with a high yield and little volatility. Prior to the GFC the listed infrastructure sector was considered one of the best defensive sectors, but the sector has had to re-earn its stripes.

The credit crunch took an especially hard toll on listed infrastructure, as entities perceived to have high debt levels were hammered. For example, ports, road, rail and airports operator Asciano (AIO) fell 96% from peak to trough. The carnage was indiscriminate: Hastings Diversified Utilities Fund, now a part of pipeline operator APA Group (APA), lost 93%, even though it was regarded as one of the higher-quality members of the infrastructure sector, with assets including gas pipelines in Australia and water utilities in the UK, and a relatively high dividend yield funded from cash flow.

What investors might not have realised was that many infrastructure assets were geared beyond what their cash flows could support. When the credit crunch effectively closed the bank debt and bond markets – and sent credit spreads for infrastructure assets surging by 1% – the 70% gearing levels that were common in the sector proved too high, particularly for infrastructure stocks where the market saw short-term refinancing risk.

The sector learned a painful lesson – that if an asset is over-geared, it actually becomes a different kind of asset; and reliability of cash flow is paramount.

Defensive tag didn't help

The listed infrastructure sector can throw up very competitive yields, but the yields have to be balanced against the reliability of the cash flows.

Even then, 'listed' is the operative word: investors can hardly expect infrastructure stocks to be immune to a market slump: in the GFC, even the stocks with most of their earnings regulated – such as electricity distributor Spark Infrastructure (SKI), electricity and gas transmission and distribution group SP AusNet (SPN) and gas pipeline operator APA Group (APA) – fell by more than 50%.

These were all considered to have very defensive earnings profiles, but it didn't help when investors panicked.

Still, the predictable and stable earnings profiles of infrastructure stocks can come in very handy for SMSF investors in building an income portfolio, with the proviso that franking credits – so helpful to SMSFs in augmenting the after-tax yields on company dividend flows – are not usually available, because of the heavy depreciation and amortisation (D&A) requirements that render statutory profit close to zero.

Remember, a 5% fully franked dividend is worth 6.07% (5 x 1.215) to an SMSF in accumulation mode, because the fund (which is taxed at 15%) receives $215 worth of refunded franking credits on every $1,000 of dividend income; while the same dividend is effectively worth 7.14% (5 x 1.428) to the SMSF, because it receives the franking credits in full.

Good yields

That understood, there are some good yield situations available in the infrastructure space.

For example, market consensus projects SP AusNet

(SPN) as offering a 7.4% yield in FY14. (This yield is expected to be 33% franked, which equates to a grossed-up yield of about 8.4%.) SPN manages a regulated network of electricity and gas distribution networks that serves more than one million customers in south-east Australia. Critically, almost 90% of SPN´s revenues are regulated.

Similarly, Spark Infrastructure (SKI) has about 80% of its revenues regulated. SKI owns 49% interests in three electricity distribution companies: Powercor and CitiPower in Victoria and ETSA in South Australia. It is trading on a 6.5% yield for FY 13, unfranked (some brokers reckon this is as high as 7.2%.)

SP AusNet and Spark Infrastructure both have revenue re-sets every five years. (SP Ausnet's gas distribution assets come up for re-set this year, the electricity transmission asset in 2014 and the electricity distribution asset resets in 2016. Spark is up for re-set in 2015 and 2016.)

Market consensus has energy infrastructure owner DUET Group (DUE) on a distribution yield of 8.1%, unfranked, for FY14. DUET has more than 90% of its revenue regulated or under long-term contracts. It owns 80% of the Dampier to Bunbury gas Pipeline (DBP) in Western Australia, 100% of Victorian gas distributor Multinet Gas and 66% of Victorian electricity distributor United Energy. Multinet comes up for regulatory reset this month: United Energy and DBP are intact until January 2016.

The unfranked yield on DUET to a SMSF in accumulation mode is equivalent to a 6.7% fully franked yield; in pension mode, the fund needs to be earning 5.7% fully franked to beat the DUET yield.

Less regulation, more growth

While 'regulated earnings' sounds reassuring, where there is less regulation, there is greater scope for distributions to grow. For example, toll road operator Transurban (TCL) is able to benefit both from rising traffic volumes on its roads, and rising tolls, which grow at CPI (the inflation rate), or 3.5% – 4%, whichever is higher.

TCL owns Melbourne's CityLink and Sydney's Hills M2, and owns 75% of the M1 Eastern Distributor (Sydney) and 50% of the M5 and M7 (also Sydney). It also owns three roads in the USA.

Market consensus puts Transurban on a 5.6% yield, 25% franked, in FY 14. While this is not as attractive at first sight as some of the other infrastructure yields, Transurban should be able to grow its distribution by 10% a year until at least 2025 (its CityLink concession expires in 2034.) With this scope for growth, Transurban looks very much like the pick of the infrastructure stocks on yield grounds.

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Consumer discretionary sector in focus

by Ron Bewley

There are 11 stocks in the Consumer Discretionary sector of the ASX 100 – which are all listed in the Table. Five are stocks associated with gambling (TTS, CWN, EGP, TAH, ALL), three are retail store chains (MYR, DJS, HVN) and two are media (NWS, FXJ). The remaining stock is Flight Centre. News Corp dominates in size, being 41.2% of the sectors market capitalisation in the ASX 200.

I sold out of this sector in May 2011, having been burned a couple of times in HVN and I have not returned since. I exited NWS quite some time before. However, Consumer Discretionary has been one of the standout sectors for the year – but it was coming from a low base.

I'm not against gambling – as many 'ethical investors' are. My problem is that these stocks can be very much affected by changes in regulation, which might not be flagged in advance. Media companies are going through a major transition, given the impact of the internet on the manner in which consumers take delivery of content – and how to charge for it. Need I say more about retail stores? Australians have changed their savings habits and the internet is also impacting this sector.

My views are largely reflected in consenus recommendations. Only three pass my 2.5 rule (please see my paper on this on www.woodhall.com.au under the Market Update tab). They are NWS, CWN and FLT.

Turning to Chart 1, I note that FLTs recommendation, while being very good, has been slipping for 12 months – but it did improve in the last two days. I'd monitor this recommendation a little while longer before I'd consider buying (please see chart at the end of this article).

The NWS was also very good until the second half of last year. But again, it did improve in the last couple of days.

CWN has the best recommendation but it too has slipped a bit. This looks to be the best of the bunch on recommendations alone.

FLTs price is above its median target price and CWN is on it. NWS has room for capital gains based on the median price. All three have had massive growth in the last 12 months: NWS (40%), CWN (38%), FLT (63%).

The exuberance chart shows the current drama. Mispricing is currently 4.8%, which is not far below our 'trigger point' of 6% for a correction. The ASX 200 has just been through seven consecutive weeks of gains. This sector is all looking a bit much to me (please see chart at the end of this article).

The only stock that interests me in this sector is Flight Centre but today doesn't seem to be the best time to buy – at least according to broker forecasts of target prices, our measure of exuberance, and the strength of the trend. If we look back to my last two papers – both on the materials sectors, most of the stocks have so far done quite well – and that's consistent with my way of analysing stocks and sectors as I discuss in that paper on our website.

Ron Bewley is the Executive Director of Woodhall Investment Research.

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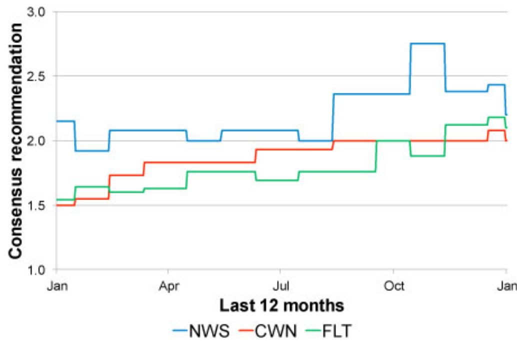
Chart 1: Variation in consensus recommendations for selected stocks



Note: the estimates in the Figure are current to the close of business 4 January 2013. They are based on Thomson Reuters Datastream. The price target is the brokers' forecast of where the stock price is heading - often considered to be in the next 12 months.

Chart 2: Exuberance in the Discretionary sector

Note: the estimates in the Figure are current to the close of business 4 January 2013. They are based on Thomson Reuters Datastream. Please go to www.woodhall.com.au for more information on the assumptions behind the estimates.

Table: Data on companies in the ASX 100's Discretionary sector

Company name	Ticker		Price growth over		Price target			Consensus rec.	No. of brokers	12-month forecast		Market cap.
		Price	quarter	year	low	median	high			yield	P/E	share
NEWS CORP.CDI.'B' (ASX)	A:NWS	25.63	3.1%	40.4%	21.06	28.48	30.15	2.2	8	0.9%	14.2	41.2%
TATTS GROUP	A:TTS	3.13	9.8%	31.5%	2.10	2.85	3.37	3.0	13	5.1%	19.4	8.7%
CROWN	A:CWN	11.00	17.3%	38.2%	8.60	11.00	11.85	2.0	13	3.5%	16.5	8.1%
ECHO ENTERTAINMENT GROUP	A:EGP	3.49	-12.3%	1.1%	3.30	3.75	4.80	3.1	13	2.6%	18.9	5.0%
TABCORP HOLDINGS	A:TAH	3.10	8.4%	11.5%	2.60	2.98	3.30	3.1	13	5.2%	15.8	4.0%
FLIGHT CENTRE	A:FLT	27.32	7.1%	62.6%	23.30	26.75	29.50	2.1	17	4.7%	12.2	3.1%
MYER HOLDINGS	A:MYR	2.21	19.5%	12.8%	1.65	2.12	2.70	2.7	14	8.1%	9.9	2.4%
DAVID JONES	A:DJS	2.40	-5.5%	-1.6%	1.70	2.20	2.56	3.6	14	7.1%	13.0	2.3%
ARISTOCRAT LEISURE	A:ALL	3.23	16.6%	45.5%	2.45	3.00	3.50	2.9	14	3.7%	16.3	2.2%
HARVEY NORMAN HOLDINGS	A:HVN	1.93	-2.0%	4.1%	1.35	1.70	2.28	3.4	13	4.7%	11.5	2.0%
FAIRFAX MEDIA	A:FXJ	0.54	33.3%	-27.0%	0.40	0.50	0.90	3.0	13	3.7%	9.0	1.3%

Note: the estimates in the Table are current to the close of business 4th January 2013. They are based on Thomson Reuters Datastream. The price target is the brokers' forecast of where the stock price is heading - often considered to be in the next 12 months.

Question of the week - views on WAM and AUI

by Paul Rickard

Q. *What are your views on WAM and Australian United Investment Company (AUI)?*

We're in pension phase with an SMSF and have 50% of our funds in equities. Of this investment, we have 50% in LICs and the other 50% in good dividend paying stocks. The only downside with LICs is that their dividend distribution does not reflect the dividend yields of their underlying stocks and is only moderate. We sold some of AFIC, AUI and Argo to invest in higher dividend paying stocks including WAM. What are your views? Thank you.

A. Thanks for the question.

WAM and AUI are very different companies. The former is largely investing in small caps and higher growth companies – the latter in the major (top 25) index stocks.

AUI's investment record over the last three years is pretty disappointing, compared to AFIC or Argo - and stock liquidity (as represented by the bid/offer spread) is not great. We would invest in AFIC or Argo in preference to AUI.

We are a fan of WAM (if used as a vehicle to invest in the smaller end of the market) – and the investment is weighted accordingly.

Potentially, you might have say 75% to 80% in the major mainstream LICs such as Argo or AFIC, or directly in a portfolio of major shares, with 10 to 20% in WAM and/or another smaller companies manager. With any manager of small companies, there is more "manager risk" – so we would be more inclined to split this component over a couple of managers.

We hope this helps.

Don't miss this

Shane Oliver, George Boubouras and Rudi Filapek-Vandyck joined me on Switzer on Sky News Business Channel at the end of 2012 to discuss the outlook for the economy and the stock market this year. Watch part 1 and part 2 now on Super TV.