Switzer Super Report

Thursday 6 August 2015

Bull baiting

Charlie Aitken is a good mate of mine and we've both been known as bulls for a very long time. Don't worry, we're not changing our stripes (or horns) any time soon, but today Charlie takes a step back and wonders if there might be a correction in store for the US market. Of course this means buying opportunities but you might need a little patience for the next few months.

And a correction in the US shouldn't have much of an impact in Australia as we've already had one. In our *Switzer Super Report Q&A*, I sat down with AMP Capital Investors Shane Oliver to discuss the market outlook and he's still betting on 6,000.

Also in the report today we've got a very interesting *Fundie's Favourite* from Wingate Asset Management – a US company that's full of gas, Praxair – and in *Buy, Sell, Hold – what the brokers say*, Harvey Norman and Wesfarmers got upgrades as earnings season kicked off.

Sincerely,

Peter Switzer

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Keep an eye out for a US correction

by Charlie Aitken

Key points

- *There is a chance of a 10% correction on Wall St, led down by the Dow Jones Industrial Average.*
- *Expected timing is for September, which is a seasonally weak period in markets.*
- *If there is a 10% correction on Wall St, the ASX200 should fall significantly less because we have already experienced a correction.*

There's certainly no lack of volatility in global and domestic equity markets at the moment and I expect that to continue into the Fed's first interest rate rise in nine years in September. While the Fed's likely rate rise is well telegraphed, the market reaction in the US dollar, bonds and equities is unlikely to be subdued. It will be a buy, sell and trade the fact across asset classes.

Pressing pause

As regular readers know, I generally have a bullish disposure. That has served me well over the years. However, right at the moment I am unsure of what comes next and would describe myself more as "neutral", particularly on US equities where the broader price action looks a little tired.

In terms of US equities the key problem is "breadth deteriorating" and "momentum reversing" in a number of key index weight stocks, most noteably Apple, which recently broke back down through its 200-day moving average. The one-year Apple chart is below.

While only a technical development, the reversal in Apple momentum, when combined with the falls in heavyweight oil stocks and some IT stocks, has also seen the Dow Jones Industrial Average break its 200-day moving average.

Dow stocks have been feeling the most pressure, in earnings terms, from the resurgent US dollar. It's also worth remembering that the Dow doesn't include Google, Amazon, Facebook, Netflicks or Amgen that have helped drive outperformance of the S&P500 and Nasdaq 100 this year.

The Dow's EPS growth has been lacking and next quarter will see another fall in earnings, albeit just -2%. In my experience it remains difficult for an index to advance if earnings are going backwards. It's worth noting the Dow component Disney downgrading its outlook last night and its subsequent 9% fall.

The five-year chart below suggests to me there is near-term downside risk n the Dow Jones Industrial Average on a purely technical basis. The 50, 100 and 200-day moving averages have broken and it may suggest the Dow is headed to the next support level around 16,000.

Possible US correction

What I am trying to tell you is I think there is a chance of a -10% correction on Wall St, led down by the Dow Jones Industrial Average. The Dow Jones Transportation Average (Dow Transports) has recently experienced a correction DESPITE the oil price making new lows. People who follow "Dow Theory" would subscribe to the view that the Dow itself will follow the Dow Transportation Average's correction.

It's fair to say no equity market has had central bank support for longer, or in larger scale, than US equities – $4.5 trillion on QE, forcing investors from cash and fixed interest into equities, and 0% cash rates for seven years.

A previously devalued US dollar drove converted US equities EPS growth, while buybacks went to a scale never before seen, generating near to 50% of total EPS growth in the last 5 years. I suspect I am NOT ALONE wondering how US equities will perform with a higher US dollar and less support from the Federal Reserve. In a world dominated by central banks, my strategy remains to place my biggest long bets where there is the BIGGEST central bank support (Europe, Japan, Australia for income).

Vice versa also applies and that is why my fund has very limited US equity holdings at this point and is running some tactical index futures shorts. I think patience will be rewarded here in the next few months and I will be looking to take advantage of a -10% pullback on Wall St if it comes.

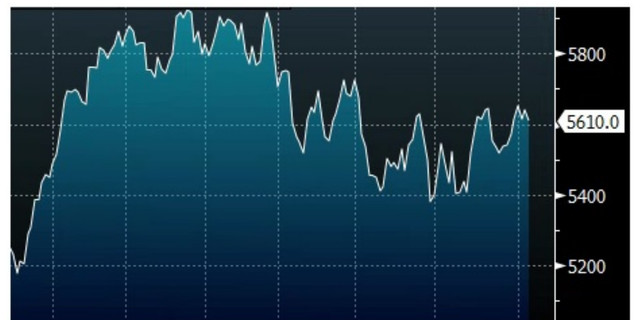
Timing is everything

The timing I suspect will be September, which is a seasonally weak period in markets. This year September will see the first Fed rate rise, and when you overlay seasonality and weak technical, you can see how it could turn into a -10% correction.

I suspect many investors are saying "so what" and that's fair enough, but if I am right and Wall St corrects -10% in September then it will coincide with the period when Australian equities are ex final dividends and the S&P/ASX 200 loses physical dividend support.

What tends to happen is the 45 days leading up to the final dividend period in August is that the ASX200 does well, then in September the market struggles ex-dividend and comes under some DRP (dividend reinvestment plan) pressure. This year's DRP pressure could be pretty big, led by the CBA DRP.

If this all plays out, I would expect the ASX200 ex-dividend to trade down to the level of 5400. The chart below is of the September ASX200 SPI Futures, which are priced effectively ex-dividend. They suggest we may have seen the best of the "cum-dividend" full year results rally and a US led pullback is pending.



Some buffer

Don't get me wrong: if there is a 10% correction on Wall St there's no doubt in my mind the ASX200 would fall significantly less because we have already experienced a correction. It would be another buying opportunity in the right Australian (and global) equities, but one worth waiting for in my opinion.

They say patience is a virtue. I believe over the next few months patience will reward investors as we head into the first Fed rate rise in nine years. Just keep a little firepower dry – a better buying opportunity may well present itself in the months ahead.

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Buy, Sell, Hold – what the brokers say 6/8

by Staff Reporter

In the good books

Credit Suisse upgraded Harvey Norman Holdings (HVN) to Outperform from Neutral. Buy/Hold/Sell 5/1/2 Credit Suisse says the FY15 results should show strong sales in large electrical appliances and furniture and a strong performance in NSW. Credit Suisse expects that, as a consequence, sales growth should accelerate and franchise profitability will improve significantly.

Citi upgraded Resmed (RMD) to Neutral from Sell, and Morgan Stanley upgraded from Equal-weight to Over-weight following financial results. Buy/Hold/Sell 4/2/2 Citi says revenue and flow generator sales were better than expected in the fourth quarter and expects momentum in this category to continue in the near term. Morgan Stanley believes the underlying business remains strong, despite a disappointing third quarter, and expects continuing growth in the US market in the first quarter of FY16. (See downgrade)

Credit Suisse upgraded Wesfarmers (WES) to Neutral from Underperform. Buy/Hold/Sell 0/7/1 The broker expects sales and earnings growth from its retail divisions will be in line. The supermarket pricing environment does present some potential for downside. Coal price guidance for the fourth quarter has been incorporated along with the broker's coal price forecasts.

In the not-so-good books

UBS downgraded Genworth Mortgage Insurance Australia (GMA) to Neutral from Buy. Buy/Hold/Sell 1/2/0 First half results were weaker than expected. The broker has become cautious on the emerging trends in the mining-exposed segments of the portfolio. Capital management remains a positive aspect of the broker's outlook but further significant returns may be dependent on no material deterioration in the economic backdrop.

Deutsche Bank downgraded Resmed (RMD) to Sell from Hold. Buy/Hold/Sell 4/2/2 After the success of the AirSense range, Deutsche Bank is wary that FY16 will prove challenging with competitor lines being launched. FY15 results beat the broker's estimates, largely because of a substantial rise in US device sales. Deutsche Bank lowers expected gross margins for FY16. A return to double digit growth in sales is still expected from FY17. (See upgrades)

Credit Suisse downgraded Suncorp (SUN) to Neutral from Outperform following its financial results. Buy/Hold/Sell 0/6/2 FY15 cash earnings were above the broker's forecasts. The result was assisted by reserve releases and higher earnings on investment income. The share price performance in recent months was justified because of the upside risk to earnings but with the news now factored in the next leg up is expected to be difficult.

The above was compiled on reports on FNArena, which tabulates the views of eight major Australian and international stock brokers: BA-Merrill Lynch, CIMB, Citi, Credit Suisse, Deutsche Bank, JP Morgan, Macquarie and UBS.

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Super Report Q&A - Shane Oliver

by Peter Switzer

In our second *Super Report Q&A*, I sat down with AMP Capital Investors chief economist Shane Oliver to talk about his outlook for the economy and the stock market.

It turns out things might not be as bad as many thought. I hate to say I told you so…actually I don't hate to say it because I did tell you so!

Click the image below to watch the video.

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Sometimes, all Praxair needs is the air that you breathe

by Stuart Morgan

Key points

- *Praxair operates in an industry (industrial gasses) with high barriers to entry. It has been thorough in choosing its clients to minimise risk.*
- *Praxair has underperformed its three major competitors over the past 12 months and is now trading at a discount of one to three times 2016 earnings.*
- *Wingate values Praxair at US$136 per share.*

Stuart Morgan is an analyst at Wingate Asset Management.

How long have you held the stock?

Since March 2015. Praxair is a low-volatile stock but was down around 7% in a strongly rising market. It has dropped another 9% since then, allowing our fund to increase its position in the stock. It is currently the fund's second largest position.

What do you like about it?

Industrial gases are an essential component of a wide range of applications including food and beverage, healthcare, energy, metals, chemicals and electronics. Gases are either extracted from the air (nitrogen, oxygen, argon) or from natural gas (hydrogen, carbon dioxide). They are usually a very small cost of the end-client's expenses but the client typically cannot produce their goods without the gas in question.

Industrial gas companies have built thousands of kilometres of pipeline to link their plants together in a particular heavy-industrial area such as the Gulf Coast in the US or around Rotterdam in Europe. New plants are built on-site for clients, who sign long-term take-or-pay contracts, and linked to the existing pipeline, thus guaranteeing supply.

The industrial gases industry is a rational oligopoly with only four global players and a handful of (much smaller) regionals. The barriers to entry are high – thanks to the pipeline networks built up over decades. Intellectual property and client risk-aversion makes it exceedingly difficult for new players to enter the industry in, say, a newly-developing geographical area.

The industry typically grows at a low single digit premium to industrial production in each geography and, since consolidating over the last decade or so, is relatively resilient during economic downturns.

How is it better than its competitors?

All four industrial gas majors are of high quality, but two stand out in particular: Praxair and Air Liquide. Praxair consistently posts around a 4% higher EBIT margin and around a 6% higher return on equity than Air Liquide, which in turn is consistently higher than the other two majors. A clear indication of the two companies' differing strategies is the fact that Praxair operates in only about a dozen countries, whereas Air Liquide is present in over 100 countries.

We expect Praxair's superior margins and returns to persist. Over the past 15 years Praxair has consistently been the price-leader out of the four majors. However, Praxair has underperformed the other three majors over the past 12 months and is now trading at a discount of one to three times 2016 earnings. The relative weakness is largely due to cyclical factors, in our view.

What do you like about its management?

Industrial production has been recently weak in some of Praxair's key markets such as Brazil and

metal-production clients in the US. The key risk for industrial gas companies is that some of their on-site customers go bankrupt. Praxair's due diligence in choosing their clients has ensured that this risk is minimal.

Praxair has been pro-active in rationalising costs and should experience favourable operating leverage once the excess capacity is taken up. Additionally, Praxair has increased the return of operating cash flow to shareholders rather than seeking growth at any cost.

What is your target price on Praxair?

We value Praxair at US$136 per share.

At what point would you sell it?

Should the stock approach our assessment of intrinsic value of $136 in the next 12 months we would start to exit the stock. If, however, the outlook for 2016 improves then we would likely increase our assessment of intrinsic value.

How much has it added (subtracted) to your overall portfolio over the last 12 months?

The stock has dropped since our initial purchase however it has not materially affected the fund's performance. We continue to build the position at these attractive prices.

Is it a liquid stock?

The stock is highly liquid with a market cap of $33 billion.

Where do you see the value?

Praxair is a high-quality company with an excellent operating record and steady and strong growth prospects. Wingate will always look to get exposure to this stock whenever there is significant weakness that is cyclical in nature, such as the current weakness in Brazil and some of their US customers.

***Source**: Yahoo!7 Finance, 6 August 2015*

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Super strategy for the self-employed

by Tony Negline

Key points

- *This strategy may only be suitable for the self-employed, that is, persons who can make contributions to super and claim a personal tax deduction.*
- *It allows you to claim a tax deduction this year but have some of the contributions counted towards your concessional contribution cap next year.*
- *The ATO recently released a pro-forma document and information around this strategy here.*

This is an update of information first published in the *Switzer Super Report* in May 2012 and takes into account recent developments. At the outset, it is important to state that this strategy may only be suitable to the self-employed – that is, persons who can make contributions to super and claim a personal tax deduction.

The current concessional caps – $35,000 this financial year if you were aged at least 49 on 30 June 2014 or $30,000 for everyone else – severely restrict our ability to grow our retirement income tax effectively.

Thankfully there's a short-term solution to the problem that enables you to double your concessional contribution cap in a specific financial year.

The strategy allows you to claim a tax deduction this year but have some of the contributions counted towards your concessional contribution cap next year. So this idea isn't a huge additional concession but it might help if you already know that next year you won't be employed or will be unable to make concessional contributions.

This strategy won't work for everyone and you must think and plan carefully before using it. For example, if you need access to your concessional contribution cap next financial year for contributions made in that year then please factor that in to anything you do before 30 June in relation to this strategy. Also this strategy won't work if you don't have access to sufficient cash flow to make higher super contributions this financial year.

How does the strategy work?

Firstly I think most SMSF trust deeds will need to be amended before executing the strategy.

For the sake of simplicity and ease of administration and audit I think you should make contributions up to your relevant contribution cap during the financial year. Your super fund can then allocate these contributions immediately to your member account.

Near the end of the financial year you make additional concessional contributions to your super fund that are above this year's concessional contributions cap but below next year's concessional contributions cap.

You must make sure this contribution can be treated as a contribution this financial year by your super fund. (Don't forget that electronic funds transfer can take a few business days so leave enough time for the money to hit your super fund's bank account by 30 June).

It's important not to make all these contributions in a single transaction, **as if you do then the strategy fails**.

Your super fund's trustee holds next year's contributions in an "unallocated contributions account" as required under your trust deed.

Assuming that you can actually claim the contributions as a tax deduction this year then all the contributions made this year can be claimed as a tax deduction.

Early in the next financial year – in fact within 28 days of the contributions being made – your super fund's trustee elects to allocate these contributions to your member's account and once allocated these contributions will be reported to the ATO for concessional contributions tax purposes in the year they're allocated.

The management of the "unallocated contributions account" is important. Before the release of an ATO's Interpretative Decision and Tax Determination, it was assumed that this account had to be a reserve account. Super fund trustees have to run reserve accounts according to the super laws. For example, reserves must have their own investment strategy and money can only be distributed from them using specific tax rules.

One of the purposes of the trust deed amendments mentioned above is to remove the need to use a reserve account when you use this strategy.

The ATO says you don't need to use a reserve account, however your trust deed may impose specific requirements and you need to follow these rules unless you get your deed amended appropriately.

ATO documentation

In a welcome development that will enable you to easily implement this strategy, the ATO recently released a pro-forma document available at this link.

This associated form should be lodged with the ATO and it recommends "you lodge it with us before, or at the same time, as both the fund's SMSF annual return and your own individual income tax return are lodged. By following this recommendation you may avoid needing to deal with incorrect [tax] assessments."

The above link also contains some useful background information as well as some good examples as to how the strategy works and fails.

Can this be used for non-concessional contributions?

An obvious outstanding issue is whether this strategy could be used for non-concessional contributions. On the face of it there doesn't appear to be any reason why the concepts mentioned here wouldn't apply to non-concessional contributions. To be on the safe side you should consider applying for a Private Binding Ruling from the Tax Office so you have official documentation that contributing above the non-concessional contribution caps is acceptable.

What if you want to make concessional contributions next financial year?

Then you need to factor that into anything you do this financial year.

Seek advice

Finally, if you want to consider this strategy, we strongly recommend that you seek professional taxation advice from an accountant or other appropriately qualified expert.

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Property versus shares, Metcash and international trading

by Questions of the Week

Question 1: My wife and I have one investment property in our SMSF and one outside in our own names. My wife is concerned that we are not paying down our loans quick enough, and I think if we bought quality shares it would be a better option. The interest rate for our SMSF loan is 5.19% (principle and interest) and outside is 4.99% interest only. Should we use our spare money to pay down our loans quicker or buy shares?

Answer 1 (By Paul Rickard): This is a question that only you and your wife can really answer.

I can make a financial case – that investment in shares paying fully franked dividends of 5% will give you an effective income return of 6.07% in accumulation or 7.14% in pension – which is higher than the interest cost of 5.19%. So, from an income point of view, you would be better off in shares than paying down the loan. However, if your partner is uncomfortable with the risk in owning shares (potential capital loss), or will feel much more comfortable if the loan is extinguished – then follow that path.

I like exposure across multiple asset classes – you also need to take this into account.

Question 2: It seems that Metcash (MTS) has been increasing gradually in price and some major funds are taking positions. What is your view?

Answer 2 (By Paul Rickard): Yes, after a horrid run, Metcash (MTS) seems to have found a bottom around $1.00 and some of the funds have been building positions.

The brokers still don't like it. According to FN Arena, sentiment is still mildly negative (score of -0.3, on scale of -1.0 most negative to +1.0 most positive), with a consensus target price of $1.21.

I feel that the grocery supermarket wars have a long way to play out – so I can't get excited about MTS

Question 3: I'm interested in investing in the NYSE and would like to know the best brokering companies that offer the most seamless and cost effective options for their products/services though their online trading platforms including international share transactions in foreign currencies and/or local currencies?

Answer 3 (By Paul Rickard): CommSec offers a good service – however, unless you are going to hold a portfolio of shares, the initial custody fees are high.

NABTrade charges a lower brokerage rate and their online access is good. However a potential downside with NABTrade is that they convert each transaction back into Australian dollars – so you effectively pay a foreign exchange spread on each side, where as other services allow you to hold US dollars. For a trader, this can be an issue. Try also IG markets.

Question 4: In your experience what is the easiest and most cost effective way to transfer large sums of foreign currency into Australian dollars? In my case it would be US dollars to Australian dollars.

Answer 4 (By Paul Rickard): Banks are going to be the cheapest, but shop around and also consider Ozforex

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