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Interview on Switzer TV 12th April 2012

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Big Picture

Owing to technical issues, the time for Dr Ron Bewley's interview with Peter Switzer on Switzer TV (Sky Business, Foxtel ch. 602) was shortened at the last minute. The brief points in this note are to help any viewers better understand the tape that is stored on www.switzer.com.au given the slightly rushed nature of the interview. There is also a copy of our slides in the 'News' section of www.woodhall.com.au for the 9th April 2012.

The thrust of the interview was to explain to viewers what the 'normal' relationship is between the US and Australian stock markets given the recent disconnect between the two. In our view, the April sell-off was entirely reasonable (see the archived Woodhall's Weekly for 11th February 2012 and thereafter - as well as the monthlies) The S&P 500 had a big run at the start of 2012 - to about 13%. At the peak, Woodhall had the S&P 500 overpriced by 5%. We believe corrections - or prolonged sideways movements - often occur when there is 6% overpricing. That the S&P pulled back to 0% mispricing before starting a new climb on Wednesday (11th April) is unsurprising to us given our general views of market behaviour.

We also believe that the China slowdown is being overdone in the media. As the program went to air, it was announced that China had reported a big surge in lending. The controlled slowdown seems to be on track for a bottom and a bounce-back.

The US economy gained strength at the start of 2012 fuelled by a fall in their savings ratio (from 5% to 3.5%), improved consumer confidence and increased consumer spending. The Federal Reserve is ready and waiting to inject a stimulus - but only if required.

We believe that an interest rate cut in Australia is not warranted - although there may well be one or more this year. Australia's household savings ratio climbed steeply from about 0% to 10% between 2003 - 2010 to be at levels that Australia last experienced in the seventies. If rates are cut, we think the potential savings on mortgage repayments will simply be used to reduce debt, not to increase the demand for goods and services. Australian consumers have a distinct lack of confidence as can be seen from this week's consumer confidence data.

It is not possible to say why consumers are not confident but possible candidates might be the dollar, tax policy (mining and carbon) and the government's desire to tighten the budget to create a surplus in the next financial year. If and when the household savings pull back to more normal levels - say those being experienced in the US - there will be a massive injection of growth into the economy (see our recent article in Professional Planner reproduced in our archived media papers). Nevertheless, our stock market has plenty of room to rise. We estimate that, in a long run sense, our market is about 15% underpriced (see the March 2012 interview on Switzer TV) and 0% mispriced in the short run. Our market is only about 30% above the March 2009 lows while the US and UK markets are close to their 2007 highs!

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The relationship between the US and Australian stock markets

A commonly held view seems to be that the Australian market usually just follows the US market. In Chart 1 (the scatter plot) we plot the annual growth in the All Ordinaries (All Ords) against the growth in the Dow Jones for each calendar year since 1946. Each dot represents a year and so there are 66 dots.

If the Dow and the All Ords moved together in lockstep, each dot would lie along the diagonal line. Clearly there are few dots anywhere near that line! In the top left (NW) quadrant, the growth in the All Ords is positive while the growth in the Dow is negative. In the bottom right (SE) quadrant the growth in the All Ords is negative while the growth in the Dow is positive. About one third of the dots are in these two quadrants meaning that for 1/3 of the time the two indexes moved in opposite directions. Of course, for many of these years, one of the growths was close to zero - but the point remains. There is no lock-step movement in these 1/3 of the post-war years.

In the top right (NE) quadrant both growths are positive. In the 'triangle' marked 'A' above the diagonal line, the All Ords outperformed the Dow. In 'B', the Dow outperformed the All Ords. In the bottom left (SW) quadrant, both indexes fell. In the 'triangle' marked 'D', the All Ords fell more sharply than the Dow.

Since there are more dots in A and D - rather than B and C - we conclude that the All Ords tends to over-react to changes in the Dow - if indeed the Dow is the cause for change. If we had plotted a stock return against its market return, this relationship is akin to being called a 'high beta' stock - such as for a small mining company.

In Chart 2 we plot the difference between the return each year for Australia minus that for the US. Hence, when the 'bar' is above the horizontal axis, Australia outperformed the US and vice versa. There are four important features to be observed from this chart

i) The average outcome over the 66 years is only 0.2%. That is, almost the same return would have been achieved in either market - lock-step - but only in the long run.

ii) Compared to a bell-shaped curve, small differences are under-represented. That is large positive and negative outcomes occurred - compared to small ones - more often that we get from a 'typical' time series in finance.

iii) There are a number of clusters of four or five years of outcomes of large but similar magnitudes (positive or negative). But there also many cases when a single large outcome is followed by a large outcome of the opposite sign. The year-on-year correlation is very close to zero but this chart does not exhibit the pattern of a typical uncorrelated times series in finance. Indeed, there seems to be a complicated (nonlinear) pattern in the data.

iv) In most cases the switch from positive to negative (and vice versa) is very big indeed.

The conclusion from this chart alone for the current situation is that, after two years of the All Ords underperforming the Dow, we cannot predict whether this run will continue or not, but when it does change, it would not be abnormal for the All Ords to suddenly outperform the Dow to a large degree!

Our current forecasts for the next 12 months is for the Australian market to grow by 14.5% and the US by 12%. (see Woodhall's Wall Street Connections on www.woodhall.com.au under the 'Market Update' tab). However, volatility can take markets far from trend in the short run - even when the forecast is correct!

Since these results - that the Dow and the All Ords have not nearly been in lock-step - we have added three charts of daily data that might help some viewers bridge the gap between their experiences and our research. They show that close lock-step movement often happens on a daily basis but there are regime changes which break these patterns in the longer run.

In Chart 3, we show daily movements in the ASX 200 and the S&P 500 for 2008 and 2009. We have rescaled the S&P 500 to start at the same point as the ASX 200 to focus on the common trend. This rescaling has no impact on the integrity of our analysis. In our opinion, these two indexes moved very closely together for two years on a daily basis.

The next chart (4) shows the indexes for the next 20 months (January 2010 - August 2011). Again the relationship was very close but this time we have converted the ASX 200 to $US as a foreigner, who is fully hedged, might view our index. (See 'It's still the dollar', a paper of ours listed on our website under the tab 'Market Updates' and then Feature Papers to understand this point)

In our view, fear was heightened during 2008 and 2009 so our market, in the absence of specific information on the future of Australia, followed the US very closely. The markets were much more settled in 2010 and 2011 (up to the end of August 2011). QE 2 - the monetary expansion in the US - made Australia a viable alternative to the US during this highly volatile period for our exchange rate only when the markets were both considered in the same currency. The heighted volatility in September 2011 until the end of 2011 destroyed that common-currency movement.

In Chart 4, the two indexes in their own currencies are plotted until the present. A very wide gap emerged between the two indexes. So what does this mean for investors? From time to time there can be a close correspondence between the two indexes but these relationships can break sharply. In the last two weeks we have observed that the flow-on the overnight US market has been muted. Has a new relationship begun?

The big lag from the US to Australia could be eroded quickly - at least it would not be unusual based on historical data. Indeed, the 'unusual' is more common the 'usual' when we look back.

Our views on these markets are updated each week and month on our website. Markets are notoriously difficult to predict but they are currently 'on track' with our research. We think the worst is behind us and we have a lot of catching up to do. When it will start we do not know but if and when it does start it might happen so quickly as to catch many investors by surprise.