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Woodhall's ASX 200 Prospects for 2014

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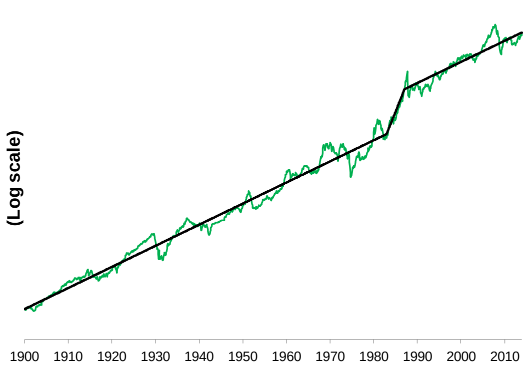
This rally looks to have 'skinny' legs

- **The sell-off from late October followed the overpricing in bank stocks pre ex-div**
- **Our market is not now overpriced in the long-run nor short-run**
- **Expected capital gains are above trend but below those for 2013**

Long-run mispricing

Our analysis summarised in Chart 1 suggests that the All Ordinaries has trended at 5.1% pa capital gain from 1900 to 2013 – except for a short growth spurt in the 80's accompanying the floating of our dollar and the internationalisation of our economy. The trend post the 80's was not constrained to be the same as the 80-year period prior to the 1980s but it turned out to be the same to two significant figures! The details of the trend specification and estimation are beyond the scope of this note. The analysis does, however, involve carefully constructed advanced econometric methods.

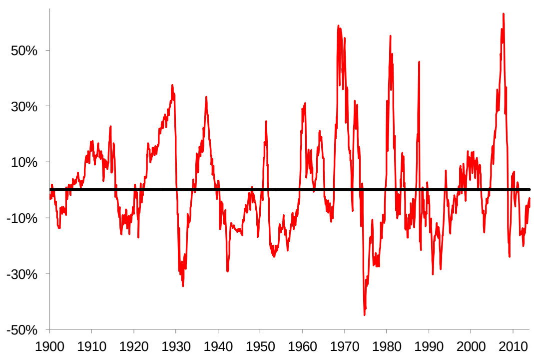
Chart 1: All Ordinaries trend-line



Source: Thomson Reuters Datastream; Woodhall Investment Research, and Wren Research

The ratio of the All Ords to the trend line gives an estimate of long-run mispricing – in Chart 2. A positive value means that the market was judged to have been expensive (ahead of trend) and a negative value means it was cheap (below trend). It so happens that the average period of overpricing is about 18 months – as is the average period of underpricing.

Chart 2: All Ordinaries long-run mispricing



Source: Thomson Reuters Datastream; Woodhall Investment Research, and Wren Research

It also follows that our market was overpriced by over 50% at the 2007 peak. There were two unusual factors at work that can explain this mispricing. First the China mining boom was at a peak in the run-up to the Beijing Olympics. Second, superannuation laws had just been changed to allow individuals to deposit $1m into tax-effective environments – to be followed up by a further $450,000 deposit after mid-2007.

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Of course, in real time, it was not clear in 2007 whether another break – such as that in the 80s – was as at work due to there being long-run China super cycle, or not.

In conclusion, this long-run analysis does not suggest a cyclical correction is either necessary or likely in the near future. As a result of this analysis it is unsurprising that our market – unlike many overseas markets – has not yet regained its all-time high.

Sector allocations and returns

The ASX 200 is dominated in market capitalisation share by four big banks in the Financials-x-REITS sector, BHP and RIO in the Materials sector, and Telstra in the Telco sector. The sector shares are shown in Table 1.

Table 1: Market shares and 2013 capital gains by sector

Sector	Market share end 2013	2013 Cap gain
Energy	5.8%	9.8%
Materials	17.5%	-3.7%
Industrials	6.4%	11.7%
Consumer Discretionary	4.5%	36.3%
Consumer Staples	8.2%	12.9%
Healthcare	4.6%	23.5%
Financials-x-REITS	39.2%	28.1%
REITS	6.4%	1.1%
IT	0.7%	24.3%
Telco	5.1%	21.8%
Utilities	1.6%	2.3%
Total	100.0%	15.1%

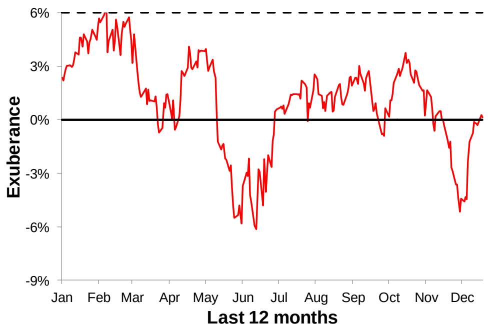
Source: Thomson Reuters Datastream; and Woodhall Investment Research.

The capital gains for 2013 have been quite disparate for the ASX 200. Materials stocks for the ASX 200 have lost ground but 20%+ returns have been made in five of the 11 sectors. In aggregate, the broader index rose by +15.1% and, including reinvested dividends but not franking credits, the total return was +20.2%. All-in-all it was a great year for the index and even better for some sectors!

Short-run mispricing

Our short-run model is based on broker forecasts and it is described on our website. Exuberance is shown for the ASX 200 in Chart 3 for the last 12 months. We also produce exuberance measures by sector. Again a positive number denotes overpricing and a negative underpricing.

Chart 3: ASX 200 mispricing

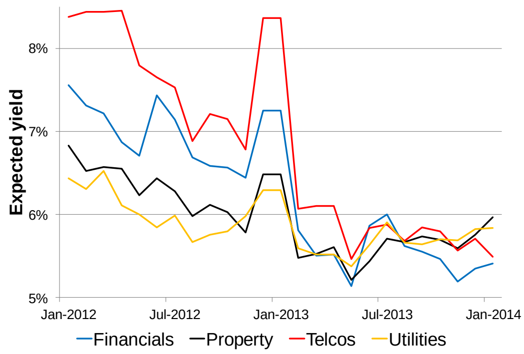


Source: Thomson Reuters Datastream; and Woodhall Investment Research; data to close 31st December 2013

As a rule of thumb used for more than a decade, a +6% overpricing has proven to be a reasonable trigger to call a correction of -6% to -10% – or a prolonged sideways market movement while the fundamental 'catches up' to erode the overpricing. The size of the trigger (+6%) was chosen on empirical grounds and it has not been necessary to update that number since.

We called a correction for the ASX 200 in late February 2013. In September 2013 we called a correction for the prices of the big banks using the Financials' sector mispricing trigger. We supplemented this analysis on banking with a dividend-compression analysis summarised in Chart 4.

Chart 4: Dividend compression



Source: Thomson Reuters Datastream; and Woodhall Investment Research; data to close 31st December 2013

What has happened over the last two years is capital has chased yield in these four high-yield sectors. As the chase progressed, stock prices rose and so yields fell – and compressed them into a tight range. At some point, yield-chasing should stop because cash is an option and an equity risk premium needs to be earned above cash.

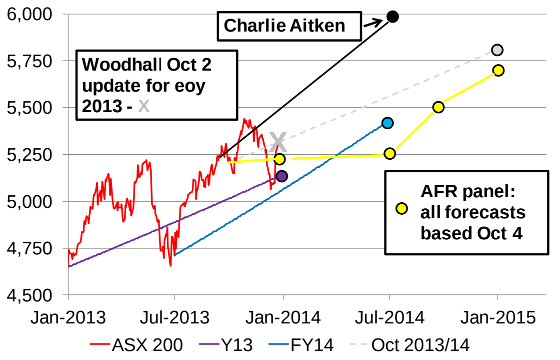
It seems that about 5.1% is the floor for yield in these sectors that investors do not want to cross. It can be seen that in September/October 2013, Financials(x-REITS) temporarily broke away from the pack as three of the big banks were due to go ex-dividend – and then the price of stocks in Financials corrected such that the four yields again compressed.

Forecasts for 2014

We make 12-month-ahead forecasts for the ASX 200 and its sectors based on broker forecasts of dividends and earnings. These forecasts are updated daily on a rolling 12-month basis.

Our recent track record is shown in Chart 5. Even normal market volatility makes any thought of accuracy on a given day dubious at best. It is not the forecast number that should be important, it is the actions the forecast encourages and the difference between one's forecast and those of others that matter most.

Chart 5: 12-month forecasts of ASX 200



Source: Thomson Reuters Datastream; and Woodhall Investment Research; data to close 31st December 2013 The navy, blue and grey circles are 12-month forecasts from Woodhall that have not been updated. Aitken's forecast was made in late September.

Our forecast for e-o-y 2013 (navy circle) made on January 1st 2013 was 5,150 when an AFR survey of 11 major brokers reported only a 29 point increase over the whole year – to finish 2013 at 4,678! The index at the beginning of 2013 was 4,649. The October 4th update of that AFR survey is also shown in Chart 6 (in yellow) together with the October 2nd update of our rolling forecasts in grey.

We made a strong statement that 6,000 might not be breached until 2015 – on a sustainable basis – on Switzer TV, October 2nd. At the time the index was on a charge to 5,441 (that occurred on 28th October). Charlie Aitken, CEO of Bell Potter, was on the same Switzer programme a few days before and he forecast that the index would be 6,000 at June 30, 2014. He has since pushed the date out for his forecast of 6,000 to e-o-y 2014. Our comment was made in response to Aitken's.

As it turns out, our Jan 1 forecast of 5,150 was 200 points short on the day (5,252) – but well ahead of the AFR consensus view made at Jan 1. The index crossed 5,150 in the last 10 days of the year to finish very close to our October 2nd updated forecast of 5,300 – which was updated to 5,350 on November 1st.

Going forward, our e-o-y for 2013/14 is 5,600 and 5,800 for e-o-y 2014. Our rolling capital gains forecasts have been in decline over 2013 from +12.5% to +8.8% as of the end of 2013. With the yield on Financials near our estimate of its floor, and being 40% of the index, the rest of the sectors will have to do all of the heavy lifting. This cap on growth in yield stocks to preserve yield is our main reason for disagreeing with Aitken. Our specific forecasts are presented in Table 2.

Importantly, we now also produce a forecast for the peak of the index in each year to supplement our e-o-y prediction. Since there is volatility and growth (trend) in our froecast, it is quite likely that a peak will occur that is significantly higher than that at the end of the year – unless the volatility is so low, or the trend is so strong, as to compress the variations around trend. Our forecast for the peak in 2014 is 6,100 and we believe this peak is likely to occur sometime after August 2014. This peak forecast does not yet take the dividend constraint into account and, therefore, might be a little on the high side. Work is continuing to refine this methodology.

Table 2: Market statistics and 2014 expectations for the ASX 200 and its sectors

	Sector	Index weights	Exuber-ance	12 month forecasts yield	cap gain	adj gain
Resource-related	Energy	5.5%	-3.6%	3.6%	21.2%	25.5%
	Materials	17.7%	0.1%	3.2%	8.8%	8.7%
	Industrials	5.9%	-0.8%	4.1%	19.6%	20.5%
High yield	Financials	39.9%	2.2%	5.4%	5.9%	3.6%
	Property	5.8%	-5.5%	6.0%	3.9%	9.5%
	Telco	5.5%	4.6%	5.5%	3.4%	-1.3%
	Utilities	1.6%	-3.4%	5.8%	10.6%	14.4%
Other	Discretionary	4.1%	1.6%	3.4%	13.9%	12.1%
	Staples	8.5%	-0.6%	4.6%	8.0%	8.6%
	Health	4.8%	1.8%	2.3%	12.2%	10.3%
	IT	0.8%	0.3%	3.1%	11.7%	11.4%
	ASX 200	100.0%	0.1%	4.6%	8.8%	8.6%

Source: Thomson Reuters Datastream; and Woodhall Investment Research.