28th May 2013

Equity Market Update

Ron Bewley PhD, FASSA

When the ASX 200 fell by -3.8% last week – only to back it up with a -1% fall on the open on Monday investors might well wonder whether the rally has come to an end. Most major indexes (S&P 500, FTSE, DAX, World, Emerging Markets) all fell by only around -1% or a fraction more. We think there is a neat story that defies the proposition that our market's rally is over.

Markets had rallied hard around the world for 2013 and much of 2012. We had priced the ASX 200 as being sufficiently overpriced on February 19th and 20th, 2013 to call a correction or a prolonged sideways movement. It was a call we had not made since 2009. The market happened to correct 110 points on February 21st. However, the market remained moderately overpriced until last week. Some sectors – particularly high yielding sectors were extremely overpriced but we argued the yield story could support that mispricing. We were puzzled by a similar overpricing in Consumer Discretionary, Consumer Staples and Healthcare as stocks in these sectors do not typically pay big dividends.

The S&P 500 story was quite different. Its mispricing was only moderate while ours was overheated but it did hit the critical value for a correction or prolonged mispricing on May 14th and we made the call at the time.

We do not price the Nikkei but we do note it grew by around 80% in six months or so!

We also measure 'fear' for the ASX 200 and the S&P 500. We believe overpriced fearful markets fall more quickly than stable markets – and can stay underpriced for longer. We had the ASX 200 'fearful' for the last three weeks but the S&P 500 was not fearful at all. Our market was possibly fearful because of talk about China, our dollar falling through parity and problems in our manufacturing industries.

On Wednesday 22nd night (our time) there was a discussion about easing back Quantitative Easing by the FOMC members and Bernanke's testimony. Some even suggested easing could start as early as in June. On Thursday (the next day) the Nikkei fell by more than 7% and lost 10% over Thursday/Friday/Monday. Our market had a negative shock for our Thursday open to deflate our overpriced market and we also fell sharply over those three days. Note that the USA and the UK were closed on Monday night for public holidays meaning that there was more uncertainty here to judge our market conditions from a global perspective.

It is important to note that our market did not correct in any even fashion. Over the month to date (as of Monday's close) Materials was up 1.6%, Energy up +1.5%, IT up +4.7%. But Staples was down -7.2% and Discretionary was down -5.3% eroding their mispricing back to almost fair price – they were, after all, unreasonably priced. Financials were down -7.9% bringing that sector's overpricing down to a quite moderate level. Most sectors are now safely below critical values of mispricing. Telcos are still too hot but with a legendary dividend payout to support that sector's price.

We now have fair pricing in our market at about 5,050 and have an end-of-year target of 5,400. We do not believe the S&P can continue to grow because of its overpricing and might even correct before its rally continues. Our market may well react to what is going on in the US but, being underpriced, we can start to grow again. However, our market is less likely to grow until the fear index returns to normal levels. We cannot predict when that will be but it will require a lack of bad news from all sources. Things to watch out for are the next China PMI number and the next US nonfarm payroll number – both due out in the next couple of weeks.

Woodhall Investment Research Pty Ltd (ABN 17 141 486 160).

www.woodhall.com.au

WOODHALL INVESTMENT RESEARCH